FEBRUARY 2015

Legal & General

ENGAGED INVESTOR
THE TRUSTEE MAGAZINE

DE-RISKING JOURNEYS OF LARGE PENSION SCHEMES

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FEBRUARY 2015

WHEN BIG PROVES TO BE BEAUTIFUL

The history of large scale de-risking can be spelled out in acronyms – ICI, MNOPF, TRW, BT, EMI, BAE.

These six pension funds have recently completed deals covering billions of pounds worth of liabilities, smashing the misconception that a scheme can be too big for insurance, or that the insurance market does not have the capacity to support larger deals.

It's true that the larger end of the market does have its own issues to bear in mind when de-risking. Their benefit structures are likely to be more complex as they are often created out of multiple mergers, and the sums they are dealing with make preparation even more important.

We at Engaged Investor, in association with Legal & General, wanted to know what schemes at the larger end of the market were actually thinking, and where they are on their de-risking journeys. We have surveyed more than 40 of the largest private sector schemes in the UK, each with more than £1bn of assets representing more than £150bn of assets in aggregate with an estimated £200bn of buyout liability.

We asked them what their long term de-risking objectives were, and what strategies they were using to reach them. Two thirds planned to use some form of insurance to help take risks off the table, and they were adopting various approaches to managing their assets and liabilities, readying themselves for these transactions.

As you read this report we hope you will learn from the insights and experiences of these schemes and will find the results as illuminating as we have.

Laura MacPhee, senior insight editor, Engaged Investor

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A CONTINUALLY DEVELOPING MARKET

The market for pension scheme insurance solutions has changed dramatically in the five years since I took the reins at Legal & General's bulk annuities and longevity insurance business. Over that time around £80bn of pension scheme liability has been insured and this compares to around £20bn in the previous five years. This dramatic sea change is not coincidence and has come about for a number of reasons.

Affordability has improved, with insurer investment strategies becoming more sophisticated, leading to better pricing and schemes generally experiencing better than expected investment returns. The market has become more experienced with processes becoming more streamlined and simplified for implementing both bulk annuities and longevity insurance. There have been a variety of product innovations and advisers have put in place specialist teams to focus on advising schemes on de-risking. Pension schemes have also evolved. The Pension Protection Fund Purple Book reported only 19% of schemes were closed to accrual in 2009 but 32% in 2014 and buyout liabilities have increased from £1.35trn in 2009 to £1.7trn in 2014 meaning the scale of the problem has increased. All of these factors have led to an increase in insurance de-risking activity.

We expect demand to continue to increase, especially because insurance is on the agenda of many large schemes as evidenced by this research. For example, where large schemes are looking at buy-in or buyout, almost 20% are looking to implement these strategies in the next three years alone. We have demonstrated in the last 12 months, through the £3bn buy-in with ICI and £2.5bn buyout with TRW, that size is not a barrier.

In addition, the pension scheme environment continues to evolve. From the scheme employer side, forthcoming changes to contracting out regulations have led to more scheme closures. Changes to accounting rules, such as the introduction of IAS19R have led to more employers beginning to look at ways to pro-actively remove pension scheme liability from their balance sheets. In addition, the costs per member of running DB schemes continue to escalate, with the impact of new legislation, PPF levies, and fixed advisory costs being spread over a declining number of members. We expect these factors to accelerate the de-risking timetable for many schemes.

The research demonstrates that increasing numbers of the largest schemes are adding to their de-risking toolkits. In addition, the 2014 Budget will create both challenges and opportunities for schemes. Not just the likely increased administration burden but also increased scope for managing liabilities through providing increased flexibility to scheme members.

I hope that the contents of this research provides a useful insight into how the UK's larger pension schemes are viewing insurance solutions and help to contribute towards an ever improving understanding of the insurance de-risking market.

Tom Ground, head of bulk annuities and longevity insurance, Legal & General

LARGE SCHEME DE-RISKING

INTRODUCTION

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EXECUTIVE SUMMARY

Engaged Investor and Legal & General surveyed more than 40 of the largest private sector schemes in the UK. Each had more than £1bn of assets, representing more than £150bn of assets in aggregate with an estimated £200bn of buyout liability

01 LONG TERM DE-RISKING OBJECTIVES

- Almost two thirds (64%) of schemes plan to incorporate insurance solutions into their long term de-risking strategy
- Thirty six per cent planned to implement a buy-in, while 11% were aiming for full buyout
- Almost a fifth (17%) said they would include longevity insurance in their long term plans
- The most common preparatory step that schemes had taken towards meeting these objectives was to complete a member tracing exercise (71%). Almost a third of schemes (31%) had carried out all their data-related preparation, including member tracing, GMP reconciliation, and a data and benefit audit
- Almost 70% had implemented investment strategies based on liability driven investment (LDI)
- Affordability was the main barrier that schemes identified as standing in the way of their objectives, followed by investment risk
- The main concern for sponsoring employers was the size of their cash contributions; the least important concern was the profit-and-loss cost associated with their pension schemes

02 INSURANCE SOLUTIONS

- Although two thirds of schemes were planning to incorporate insurance into their de-risking strategies, of those that had not already implemented a policy, two thirds had not yet approached the market and a third had received quotes but chosen not to proceed for various reasons

- The time horizon was generally longer for schemes looking to undertake buy-in and buyout exercises than for those interested in longevity insurance. Nearly 50% of schemes interested in bulk annuities said that they would look to insure within the next five years, and more than a third (35%) of schemes said they would seek to introduce bulk annuities in 10 years' time or more, while a quarter expected to get longevity insurance within the next three years

- Financial strength was the most important factor for 60% of schemes when selecting an insurance provider, followed by price, which a third ranked most highly

- Insurance exercises were typically carried out as a joint venture between trustees and their sponsoring employers – as they were in 63% of cases

- Buy-ins with deferred premium payments and all risk buyouts each appealed to one fifth of our survey respondents

- The most common way to evaluate the cost of insurance was on the estimated buyout or solvency basis (33%), followed by self-sufficiency (30%)

03 LIABILITY MANAGEMENT

- Trivial commutation was the most popular method for schemes to manage their liabilities – almost a quarter (23%) had carried it out already, and 40% planned to do so

- Liability management was either important or very important to meeting de-risking objectives, according to almost 70% of schemes

- Just 14% thought the increased flexibilities introduced by the 2014 Budget would have an impact on their de-risking timetables

- Two thirds of respondents thought the changes introduced by the Budget were a good idea

04 RISK MONITORING

- When asked to rank the different types of risk within their schemes, respondents said investment risk was the most serious – 41% ranked this as first on their list of risks. This was followed by longevity risk, which 28% of schemes identified as top. Insurance solutions can help schemes to remove these risks, particularly buyout, which completely removes risk

- Two thirds of schemes assessed and monitored the risks they faced using regular reports from their scheme actuary and investment consultant, while a quarter used an online analytics tool

- Forty three per cent of schemes monitored their funding level on a technical provisions basis quarterly

- Generally schemes monitored their funding levels on a buyout basis less frequently than on technical provisions. This is understandable, given the longer time horizons schemes were looking at for implementing buyout

- The vast majority (80%) of schemes received their regular buyout premium estimates from their scheme actuary, while 17% used an online analytics tool; none received their pricing from insurers

- Most (81%) were either confident or very confident that the estimates provided by their scheme actuary reflected actual market pricing

05 INVESTMENT STRATEGY

- Two thirds of schemes had already begun implementing their liability driven investment (LDI) strategies, while 10% said this would happen within the next three years. A further 10% said it would be three to five years before they began

- Thirty one per cent of schemes believed multi-asset funds would be the main growth area in the next decade. This was followed closely by illiquid investment opportunities

MARKET OVERVIEW

Laura MacPhee and Tom Ground, head of bulk annuities and longevity insurance at

Bulk annuity business has been booming – transactions disclosed in 2014 total almost £12bn and last year the ICI Pension Fund completed the largest buy-in on record, at £3bn (see case study, p21) and the TRW Pension Scheme completed the largest buyout on record, at £2.5bn (see case study, p38). Both of these arrangements were completed with Legal & General.

What is interesting to observe in the bulk annuity market is the dramatic increase in total volumes over the last three years. It is clear that this has largely been driven by activity from the larger schemes, particularly those with assets over £1bn.

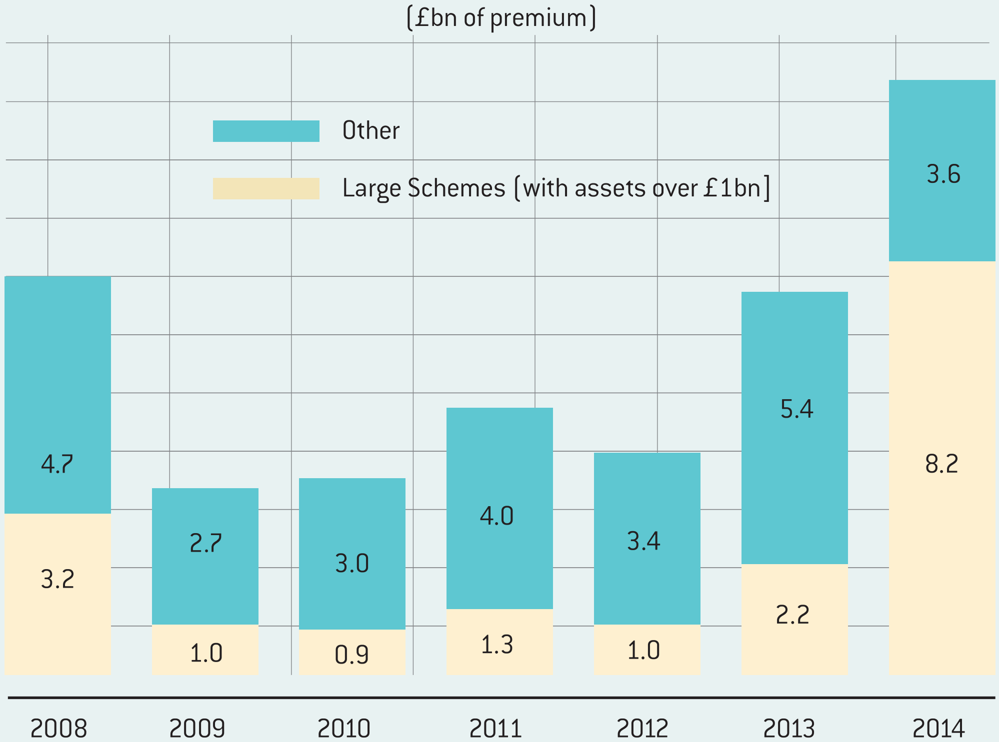
Private sector defined benefit (DB) schemes with more than £1bn in assets under management hold a substantial proportion of UK pension schemes' wealth. Collectively responsible for an estimated £0.7trn in assets, this group represents over 60% of the funds held by DB schemes in the UK. Further, these schemes are estimated to represent over £1trn of buyout liability, based on information in the Pension Protection Fund's 2014 Purple Book.

The chart below shows total market volumes since 2008 with bulk annuity arrangements (over £150m) implemented by pension schemes with over £1bn assets under management separately identified.

It is also these schemes that dominate the market for longevity hedging arrangements. Over £23bn of longevity risk was transferred to insurers and reinsurers in 2014, including the BT Pension Scheme's £16bn transaction and the £5bn arrangement agreed by the Aviva Staff Pension Scheme. This market has also picked up sharply from 2013's £8.9bn, and the amount for 2014 alone rivals the total volume of arrangements completed between 2010 and 2013 (£22.4bn).

The dramatic increase in total volumes over the last three years has largely been driven by activity from larger pension schemes

| Overview of bulk annuity market volumes since 2008 |
(£bn of premium)



Source: Legal & General Analysis

Legal & General, set the scene with an overview of the de-risking market for large schemes

| Top 3 insurance arrangements completed by UK pension schemes |

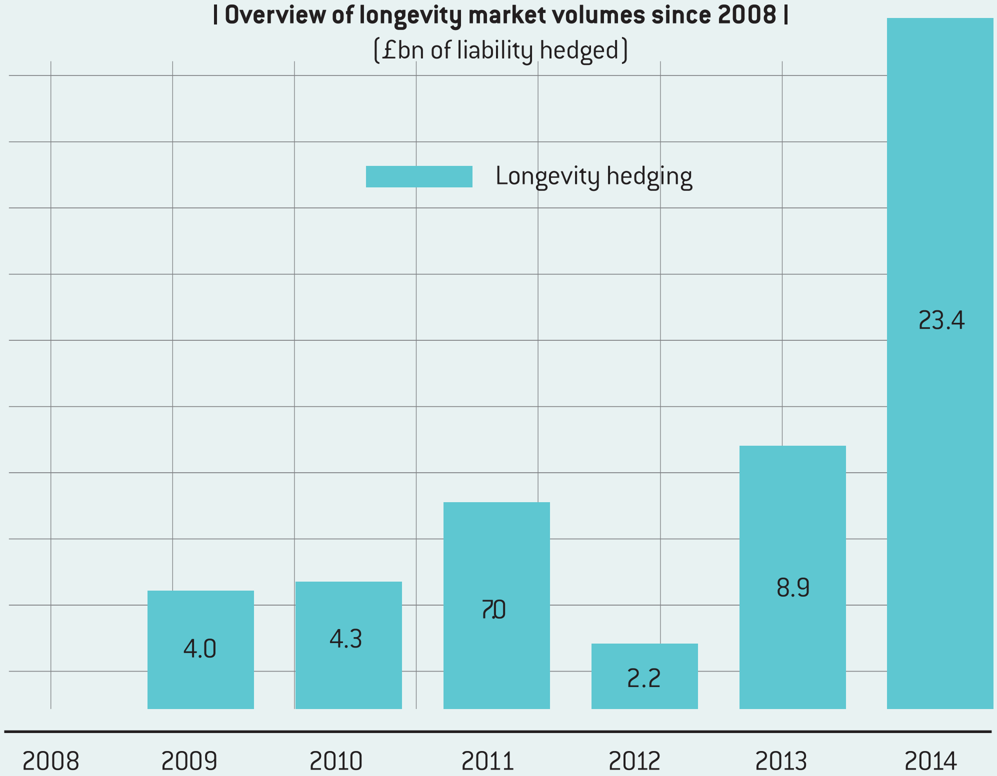
BUYOUT	BUY-IN	LONGEVITY INSURANCE*
TRW; £2.5bn; Legal & General	ICI; £3bn; Legal & General	BT; £16bn; Prudential Insurance Company of America
EMI; £1.5bn; Pension Insurance Corporation	Total; £1.6bn; Pension Insurance Corporation	Aviva; £5bn; Swiss Re / Munich Re / Scor
MNOPF; £1.3bn; Legal & General and Rothesay Life	Cable & Wireless; £1.0bn; Prudential UK	BAE Systems; £3.2bn; Legal & General

*Counterparty to whom the scheme has economic exposure

Source: press releases

| Overview of longevity market volumes since 2008 |

(£bn of liability hedged)



Source: Legal & General Analysis

"It's all about certainty. The good news is that insurance and investment solutions now let pension scheme trustees and sponsoring employers achieve this. 2014 saw deficits of private sector schemes increase by over £100bn - more than double the annual UK corporation tax bill. In reaction to volatility, 2014 saw large schemes execute a series of landmark arrangements including the largest buy-in, the largest buyout and the largest longevity hedging arrangement. These arrangements covered over £21bn of pension scheme liability."

Tom Ground, head of bulk annuities and longevity insurance, *Legal & General*

01

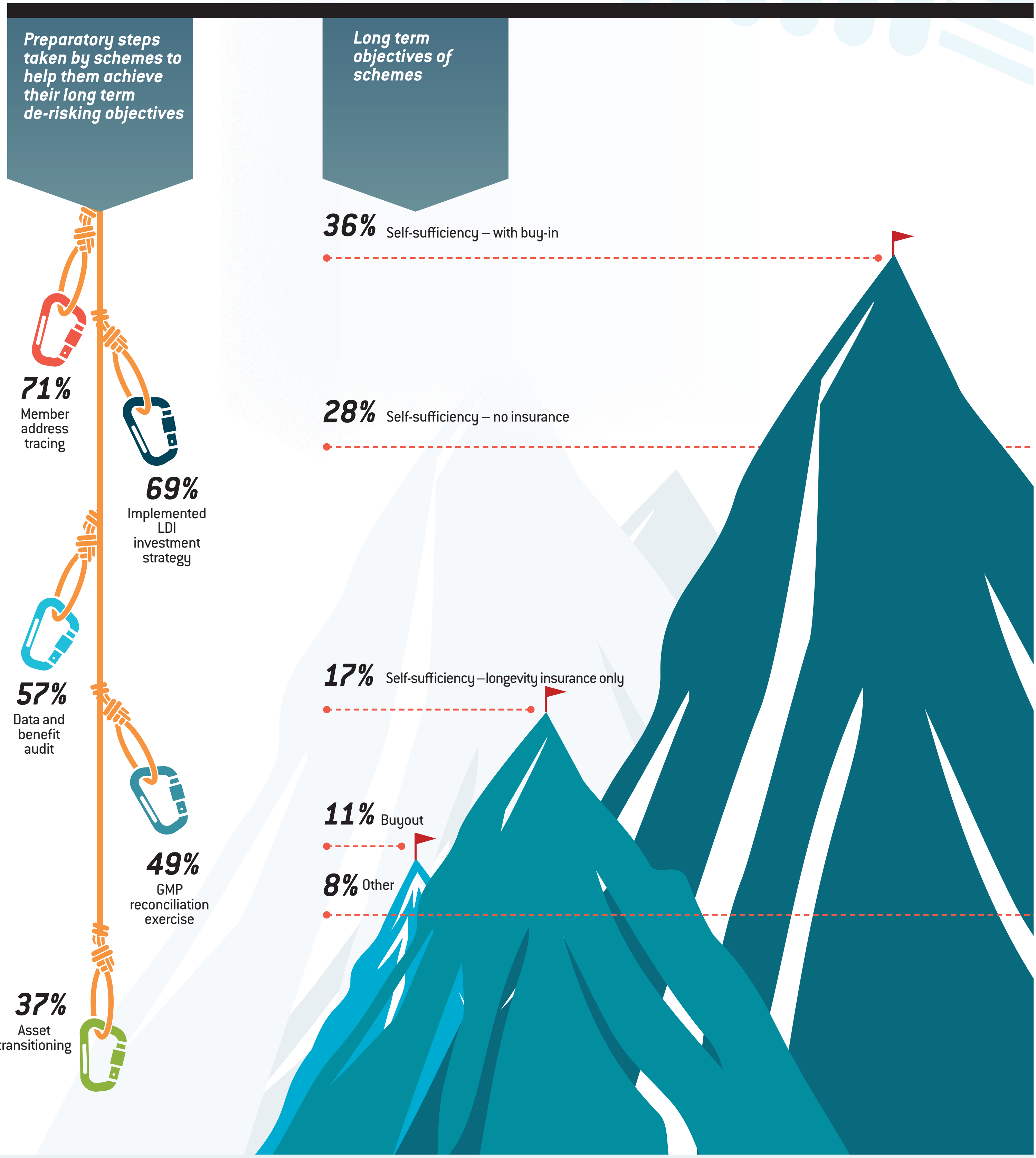
LONG TERM OBJECTIVES

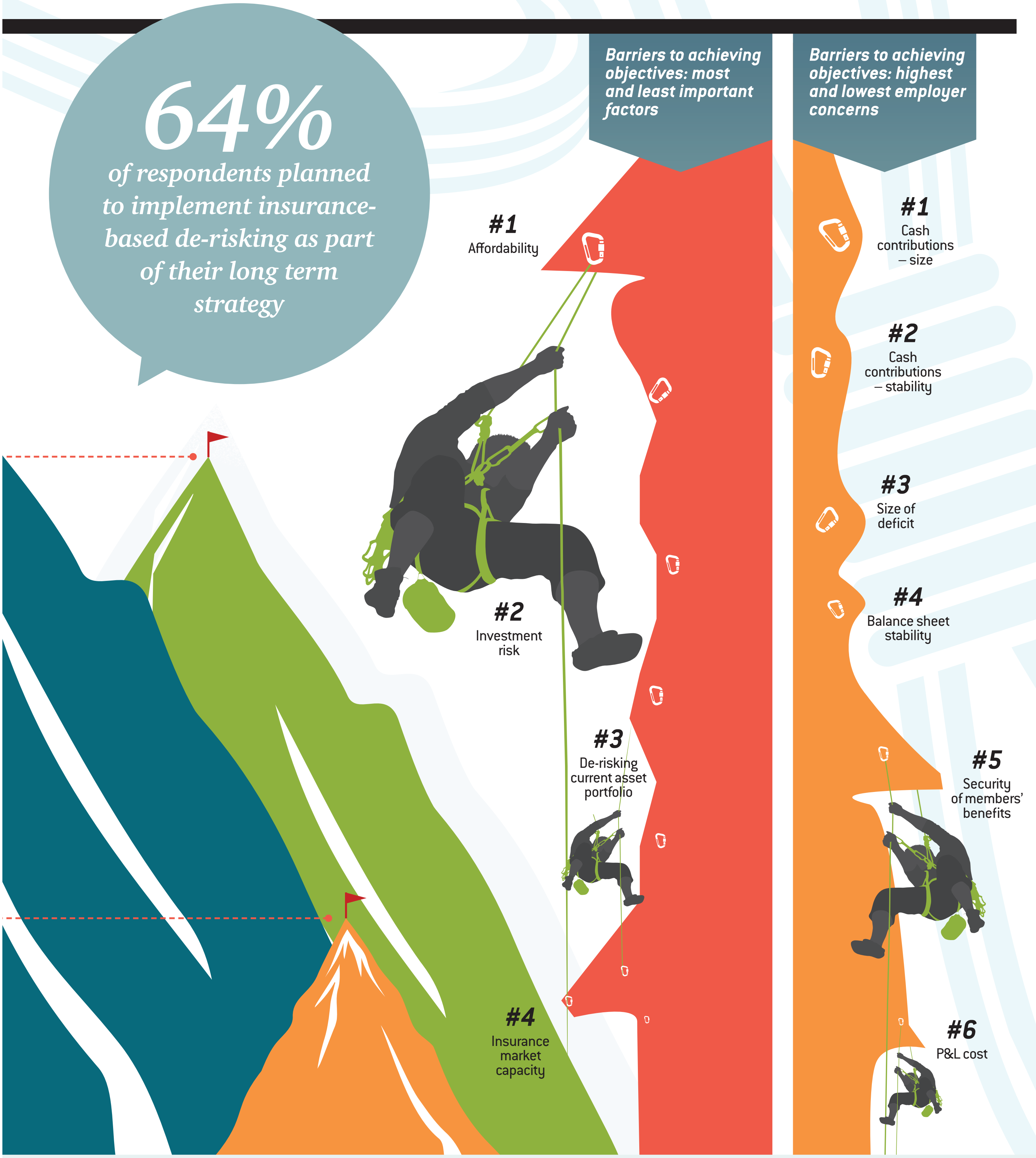
THE ENDGAME
Are large schemes targeting buyout or self-sufficiency?

THE JOURNEY
How schemes are using insurance to meet their objectives

CASE STUDY
Find out how the ICI Pension Fund removed risk in a groundbreaking de-risking deal

IN NUMBERS


Preparatory steps taken by schemes to help them achieve their long term de-risking objectives
71% Member address tracing
69% Implemented LDI investment strategy
57% Data and benefit audit
49% GMP reconciliation exercise
37% Asset transitioning
Long term objectives of schemes
36% Self-sufficiency – with buy-in
28% Self-sufficiency – no insurance
17% Self-sufficiency – longevity insurance only
11% Buyout
8% Other


64%
of respondents planned to implement insurance-based de-risking as part of their long term strategy
Barriers to achieving objectives: most and least important factors
#1
Affordability
#2
Investment risk
#3
De-risking current asset portfolio
#4
Insurance market capacity
Barriers to achieving objectives: highest and lowest employer concerns
#1
Cash contributions – size
#2
Cash contributions – stability
#3
Size of deficit
#4
Balance sheet stability
#5
Security of members' benefits
#6
P&L cost

THE LONG AND WINDING ROAD

As defined benefit pension schemes reach maturity, their trustees' thoughts are turning to what they want their funds to achieve. If trustees are going to execute a de-risking strategy to a satisfactory end point they need to be very clear about what they are looking for at the outset. Survey respondents were asked about their plans

Large defined benefit schemes clearly have insurance on their minds as a means of providing security to members' benefits.

Almost two thirds of respondents with more than £1bn in assets said they planned to incorporate some form of insurance into their long term de-risking strategies. Almost half (47%) were looking at either buy-in or buyout, while just under a fifth (17%) were considering longevity insurance.

Schemes' level of interest in insurance, and their choice of solution, was linked to the stage they had reached in their de-risking plan.

"Those that are further progressed along their journey plan are far more interested in exploring buyout than those that are at the earlier stages," says Ian Aley, a senior consultant at Towers Watson.

"As a fund gets towards the end of that journey, their target is either self-sufficiency or buyout, and therefore their funding begins to get to a level where the ultimate cost of buyout becomes attainable for them."

Knowing your trustee board's objectives before going out to the de-risking market is critical. "Trustees need to know what their options are – that's number one," says Tom Seecharan, a director at KPMG.

"Your priorities will affect the way you approach the transaction, and the content of the legal documents, so you have to be clear about them from the start," says Jane Childs, a partner at Mayer Brown.

"If you're looking at it as an investment you may not need to provide for as much flexibility as you might need if you're going to go to buyout quickly."

Before the trustees embark on de-risking negotiations they should ask themselves, and their advisers, the following questions:

- What are our objectives?
- Are we looking at de-risking as part of your overall investment strategy?
- Are we looking for support from our employer to get to buyout?
- How quickly do we want to get there?
- Do we want to get there for a specific cost?
- Do we want to de-risk all our members in one go or move them across in tranches?
- Which particular risks are we most interested in controlling?

AFFORDABILITY & COMPLEXITY

Affordability was the biggest barrier to schemes achieving their de-risking aims – 80% of schemes considered this to be the primary hindrance.

Larger schemes tend to have more complex structures, often because they have been created out of a series of mergers, so are governed by different sets of scheme rules and provide a variety of benefits to different groups of members.

"So deciding how accurately the trustee or the sponsor wants to match the benefit structure is one of the bigger decisions that needs to be made," says Anna Rogers, a partner at Mayer Brown.

Schemes will need to make that choice »

DOWN THE RABBIT HOLE

Michael Abramson, head of strategic business, bulk annuities and longevity insurance gives an insurer's perspective on large scheme insurance arrangements.

Michael Abramson
head of strategic business, bulk annuities and longevity insurance
Legal & General

The key risks associated with a pension buy-in or buyout are all too familiar to pension schemes and their sponsors, these being asset, longevity, and data risk

As an insurer, a number of potential de-risking transactions come across our desks. Some successfully complete, many do not. What distinguishes the former category from the latter? There are clearly many facets to this question, but one feature that is common to all of the successful larger de-risking transactions is full engagement with insurers. Why, you may ask, is this so important? To answer this question, let me take you down the rabbit hole and into the mind of an insurance company.

Risk, risk and more risk. It's what we thrive on, but also what keeps us awake at night. Trustees take a considered and thoroughly advised step when selecting an insurance partner to provide de-risking solutions. Equally, insurers carefully consider the risks inherent in any transaction with a pension scheme, and such risks become more pronounced the larger the transaction.

The informed taking of risks lies at the heart of an insurer's business model. For any bulk annuity, the insurer has one opportunity to charge a premium appropriate for the risks taken on. From this point on, the insurer's shareholders bear the risk of adverse developments. The key risks associated with a pension buy-in or buyout are all too familiar to pension schemes and their sponsors, these being asset, longevity and data risk. Asset risk takes many forms, the most significant ones being reinvestment and default risk. Longevity risk is simply the possibility that annuitants live longer than expected. Data risk is the potential for material errors emerging in the data used to determine the premium.

Trustees ought to take some comfort in the fact that an insurer's regulatory and governance framework requires a thorough evaluation of such risks and their management. Insurers, unlike pension schemes, are required not only to be fully funded but to hold capital as a buffer against any potential adverse developments. In a Solvency II context, this capital needs to be sufficient to withstand a 1 in 200 event.

In addition to holding this capital buffer, insurers will always seek to manage and mitigate risk. For asset risk, this means investing in a high quality asset portfolio diversified across a range of sectors and geographies to minimise the risk of default while matching the liabilities as closely as possible. Longevity risk can be managed and mitigated through a combination of strong in-house expertise (to ensure an appropriate premium is charged) and selective use of longevity reinsurance. Data risk is mitigated through detailed due diligence of the pension scheme data to identify and resolve any material concerns with its quality.

Large buy-ins and buyouts have certain unique risks, in particular around the sourcing of suitable assets without moving the market against the scheme, and any transition arrangements required to the extent that these assets differ from those held by the pension scheme. It is quite feasible that the purchase of the assets by an insurer to back a large transaction could take a number of months, so the basis risk between the assets used for premium payment and this target portfolio can be material. The insurer may need to charge a premium to accept this risk. Close collaboration between the trustees, their investment advisers and the insurer should enable such risk to be minimised, with consequential cost savings for the trustees.

Hopefully you can start to see why engagement between the pension scheme and the insurer is so important, and can make the difference between a transaction that falls at the first hurdle and one that crosses the finish line. In such a material transfer of risk from one party to another, close engagement between the two parties allows them to better understand the associated risks and to make the transfer as efficient as possible. Engagement at an appropriate level also gives encouragement to both pension scheme and insurer that they are treating the proposed risk transfer with the time, effort and seriousness that such a transaction deserves.

» before they go out to the market as it will have a significant impact on pricing. The more specifically a scheme identifies its objectives, and moves into assets that match their plans, the better the deal they can expect to forge.

Schemes that are worried about affordability can think about how their investment strategy might be able to help them. Almost 70% of the schemes surveyed had already implemented liability-driven investment (LDI) based strategies to prepare for a buy-in or buyout.

TRW Automotive is an example of a scheme that used LDI to make its partial buyout more efficient by holding assets similar to those that an insurer would want (see case study, p38).

This meant the insurer did not have to spend time and money converting the assets into a suitable form, so could lower the premium the scheme would have to pay. This kind of saving could accelerate the affordability of insurance.

"If the scheme is seeking to complete a buy-in or a buyout, transitioning their assets into the form an insurer would take can pay dividends, both in terms of price and in terms of avoidance of market risk," says Aley.

"I know we're kind of bouncing around a little bit of volatility, but if you just look in terms of trend and direction of travel, funding levels are improving," says Martin Bird, a senior partner at Aon Hewitt, who believes "the affordability gap is closing", and believes we will see an increasing number of £1bn-plus schemes de-risking using bulk annuities.

If a scheme has already carried out a buy-in there are concerns about whether or not a full buyout is affordable, and trustees may need to introduce more flexibility into their contract with the insurer.

Both parties may need to be flexible about the number of members protected by the buy-in who can go to full buyout.

"All of these options come at a price, so you're trying to decide what's cost effective for you to negotiate and to provide for future proofing," says Childs.

> ***"Having missing data and gaps in your data means that the insurer has to fill in those gaps with assumptions"***

EMPLOYER CONCERNS

The trustees and the scheme need to work together and communicate effectively if their de-risking plan is to be executed successfully. The trustees need to be sensitive to the priorities and concerns of their employers before beginning their de-risking journey.

Trustees were asked what they believed was troubling their sponsoring employers most, and affordability came up again – the top concern was the size of cash contributions (29%); only 3% responded that their employer's main concern was the impact of pensions on their profit and loss statement (P&L).

Employers could alleviate their financial fears and remove investment and longevity risks now by asking insurers about deferred premiums. Although sponsors are right to think that most transactions will require an upfront premium, there may be some flexibility with this that could give them the ability to manage cashflow while making an insurance solution possible.

If the insurer makes the option of a deferred premium available, this would mean the sponsor could pay some of the cost at a later date, or they could spread the cost over a number a years.

INSURER CAPACITY

Insurer capacity was not regarded as a significant problem by the respondents – just 7% of schemes ranked it as their top barrier, and 78% said it was their least important barrier. We expect that media reporting has contributed to scheme understanding of capacity in the insurance market.

Widespread reporting of very large transactions – such as ICI's £3bn deal, TRW's £2.5bn buyout and EMI's £1.5bn buyout – could have reassured the larger end of the market that they were not cut off from this type of solution (see p21 for a case study on ICI and p38 for a case study on TRW).

"Size doesn't really come into it," says Seecharan. "If a company can afford to buy out its scheme and has compelling reasons to do so, for example in the EMI case, they had very compelling reasons that they had to buy out."

The 2014 Budget reforms may also have had a role to play in boosting capacity. "We saw the Budget in 2014 had a massive impact on the retail annuity market," says Emma Watkins, a partner at LCP.

"That means that multi-line insurers already active in the annuity market potentially have additional capacity that they can now focus on the bulk annuity market. In my view many of them are doing that, so we've seen record levels of insurer capacity for deals in 2014 and we can expect that to continue into 2015."

PREPARATION IS KEY

As with most pensions transactions, preparation is key for those schemes that decide to go down the route of insurance based de-risking. The schemes which were surveyed had realised how important it is to be prepared before embarking on this type of exercise.

If a scheme has taken steps to be prepared it could take advantage of short lived pricing opportunities.

"I think we'll see opportunities arise that effectively come out of an insurer's ability to source assets and then wanting to deploy them really quickly," says Watkins.

"In those circumstances clearly the well prepared trustees are in a good position – the ones with really good governance structures, and the ones that have the ability and corporate support to move quickly will get [to take advantage of these opportunities]".

CLEANING UP YOUR DATA

"A relatively small amount of work on data can have a dramatic impact on improving pricing, if that work is focused on the right areas," says Ian Aley, a senior consultant at Towers Watson. So, in other words, it's well worth doing.

Most of the schemes that we spoke to had taken some steps along the way towards addressing their data. Almost three quarters (71%) had done member address tracing, and more than half (57%) had carried out a formal data and benefit audit.

"If you've got time to prepare for it over the longer term it's a very good idea to get a proper legal benefit review as well as a data review," says Mayer Brown's Rogers.

"Check through all the past documents, check whether things like equalisation of retirement ages was done properly, check whether the administrative practice actually reflects the legal entitlements."

Just under half (49%) had already completed a GMP (guaranteed minimum pension) reconciliation exercise.

"If you've got time to prepare for it over the longer term it's a very good idea to get a proper legal benefit review as well as a data review"

The reason why getting your data in good shape is important is because it is vital for the insurer to know exactly what benefits they are taking responsibility for, and therefore what premium they need to charge.

Having problems with your data affects the pricing in two ways.

"If your data is very bad that could be something that means you'll get less traction from insurers, and less traction from insurers means less competitive tension and worse pricing," says Seecharan.

"Second, actually having missing data and gaps in your data – which is quite common – means that the insurer has to fill those gaps with assumptions. Where the insurer's making assumptions they tend to be on the prudent end."

For example, if the scheme cannot provide information about how many of their members are married, the insurer may assume that more of them are married than there actually are, which will raise the price the pension fund has to pay.

Trustees may also need to audit the legal structures of the scheme because the rules may need to be amended before the transaction can take place. This is a particular issue for the larger schemes because of the»

» complexities that often arise because they are the products of various mergers.

ASSET TRANSITIONING

Asset transitioning is advisable for any scheme preparing to take the plunge into insurance-based de-risking, and 37% of schemes had already taken this step. This goes back to the idea of converting your assets into the kind of liability-matching investments insurers can use without having to convert them, which exposes insurers to additional market risk.

Transitioning your assets before going to an insurer is particularly beneficial at the larger end of the market, because the "transition risk premium" could be significant.

BUY-IN TO PREPARE FOR BUYOUT

Schemes are increasingly using buy-in as a stepping stone towards an ultimate buyout, as it will remove some of the risk and help make a complete buyout more affordable.

If a scheme wanted to go down the buyout route, there would, says Childs, "normally be a journey through buy-in first, where the premium is passed over to the insurer, who then engages in paying the trustees the monthly amounts".

This process will continue until the insurer is "satisfied that it has its administration systems up and running to then take over the administration and legal responsibility at the buyout phase".

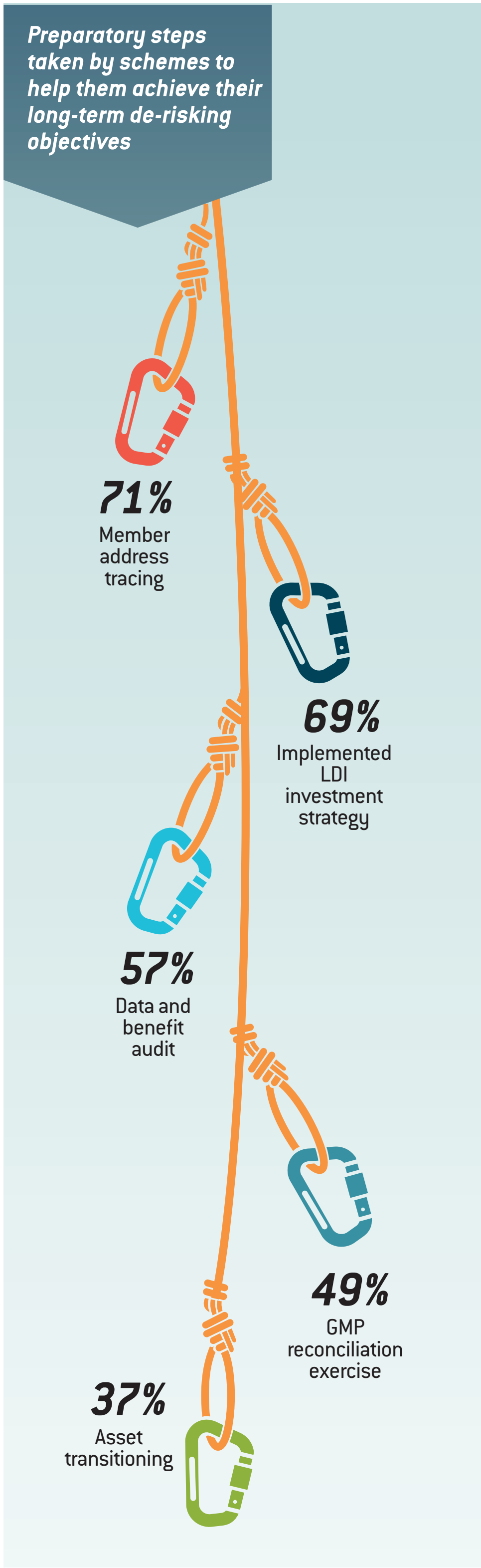
At that point, the insurer will have a direct relationship with the members and will start paying the monthly instalments to them without going through the scheme first.

We will explore buy-ins and buyouts in more depth in the next section, on insurance solutions.

SUMMARY OF OBJECTIVES

Insurance solutions, bulk annuities and longevity insurance, are very much at the forefront of the long term objectives of the UK's largest pension schemes.

The seven bulk annuity policies over £1bn have demonstrated the accessibility of insurance for the UK's largest schemes and the unique needs of these schemes.



CASE STUDY

ICI

IN MARCH 2014 THE ICI PENSION FUND COMPLETED A RECORD BUY-IN TRANSACTION, PAVING THE WAY FOR MORE MULTI-BILLION POUND DEALS

When ICI simultaneously insured £3.6bn of liabilities through collateralised buy-ins with Legal & General (£3bn) and Prudential (£0.6bn), it was a deal unrivalled in size in the UK.

David Gee, chairman of the trustee for the ICI Pension Fund, said: "The trustee has achieved a significant step in its strategy to further reduce risk in the fund. Members can be reassured that this will improve the security of their benefits by substantially reducing longevity risk for the fund."

Such de-risking transactions had not been possible before on such a large scale. It was possible for the chemicals giant to complete such a transaction thanks to months of intensive research.

Heath Mottram, chief executive of the ICI Pension Fund, said: "Investment in these buy-in policies builds on the fund's strong de-risking foundations. The transactions are the result of significant work by the trustee, including a thorough selection process and negotiation of competitive pricing and terms."

The initial investigations began in October 2013, led by ICI's advisers LCP. The fund met with insurers in November and commercial terms were agreed the following month.

The first three months of 2014 were dedicated to structuring the contract and ensuring ICI got value for money.

Michael Chatterton, independent trustee at Law Debenture, who works with the ICI scheme, said: "LCP helped negotiate competitively priced collateral structures that provide additional protections if the insurers get into financial difficulties."

The collateral agreements were critical to underpinning a buy-in contract of this size.

LCP says the contract "maintains the simplicity of a traditional buy-in contract and also includes robust additional protections to further enhance security".

Essentially this means Legal & General and Prudential had to offer up additional assets, which are held in a ring-fenced account, on which the ICI trustee can call on should either insurer default.

LCP says the assets are managed within pre-agreed investment guidelines and they are always greater than the contract value, even if this increases over time, for example as a result of improving longevity.

The assets are available to the trustee within short timescales, should the Prudential or Legal & General get into financial difficulties.

The pension fund stated: "Further investments may be considered as part of the trustee's strategy to reduce risk over time and further increase benefit security. The trustee will take such steps if it believes it is in members' interests to do so, based on professional advice and taking account of market conditions and bulk annuity pricing at the time."

SCHEME NUMBERS

£3.6bn
The size of the de-risking deals

2014
The deal was completed in March

AN INDEPENDENT VIEW OF DE-RISKING

Michael Chatterton, an independent trustee at Law Debenture, shares ten key thoughts from his experience of working on large scale de-risking transactions

Michael Chatterton
independent trustee
Law Debenture

There have been developments in the past year where insurers – and one insurer in particular – have made it clear they have an appetite for very big transactions, and the capital to deploy, such that they're going to write a significant volume of business.

There's a new transaction that has been completed with TRW Automotive – a £2.5bn buyout with Legal & General (see case study, p38). That's yet more evidence and power to my argument.

1. To the extent that plans have the assets or, in conjunction with the employer, can find the assets, then a large buyout or buy-in is a very good, oblique, perfect match for the liabilities that you're insuring. It is a very effective way of delivering the promises that have been made to the members.

2. You need to be very clear what the benefit promises are. Most large schemes have been running for very many years and often are in the state they are as a result of many mergers, so there are many different levels of benefit that have been promised.

3. The historical records are often not as comprehensive as they need to be, so there's often a lot of work needed there. In general when you move from a trust-based environment to an insurance contract – be it buy-in or buyout – you will codify the entitlement to the individual.

4. The insurer will only pay what it's promised to pay, and for a buy-in you need to be as accurate as you can, and for a buyout you need to be accurate concerning the entitlement of every member for every period of their service, so that's going to be quite a big endeavour.

5. When you've got to that point, you need to appoint a specialist manager who will be very knowledgeable in the area of the insurance marketplace. They will be an excellent project manager, and will pull together the actuarial and legal expertise that you will need to pull this large contract together.

6. You need to think hard about the assets that you have, and how to make them appear as attractive as possible, because they are going to probably be the majority of the premium that you pay the insurer with.

7. You might want to think about the assets that the insurer will need to hold to back the promises they need to be making. They will obviously be largely bond based – probably a combination of gilts and corporate bonds.

8. It's all really a question of scale. Large schemes trying to transition from whatever assets they have to the assets that the insurer wants to receive can be multi-billions of pounds. That can be significant for trading in any one day.

9. There's a danger that the market will move against you, and the market will see you coming. So you need to be very careful to disguise the counterparties, so that somebody else can't take advantage of your need to acquire certain assets.

10. The capacity that's been spoken about is only in the region of £20bn. That's only a few large deals. In the context of £2trn of DB promises that have been made in the private sector, there's still a long way to go, but there will be, I believe, more large £1bn-plus deals over the next year.

02

INSURANCE SOLUTIONS

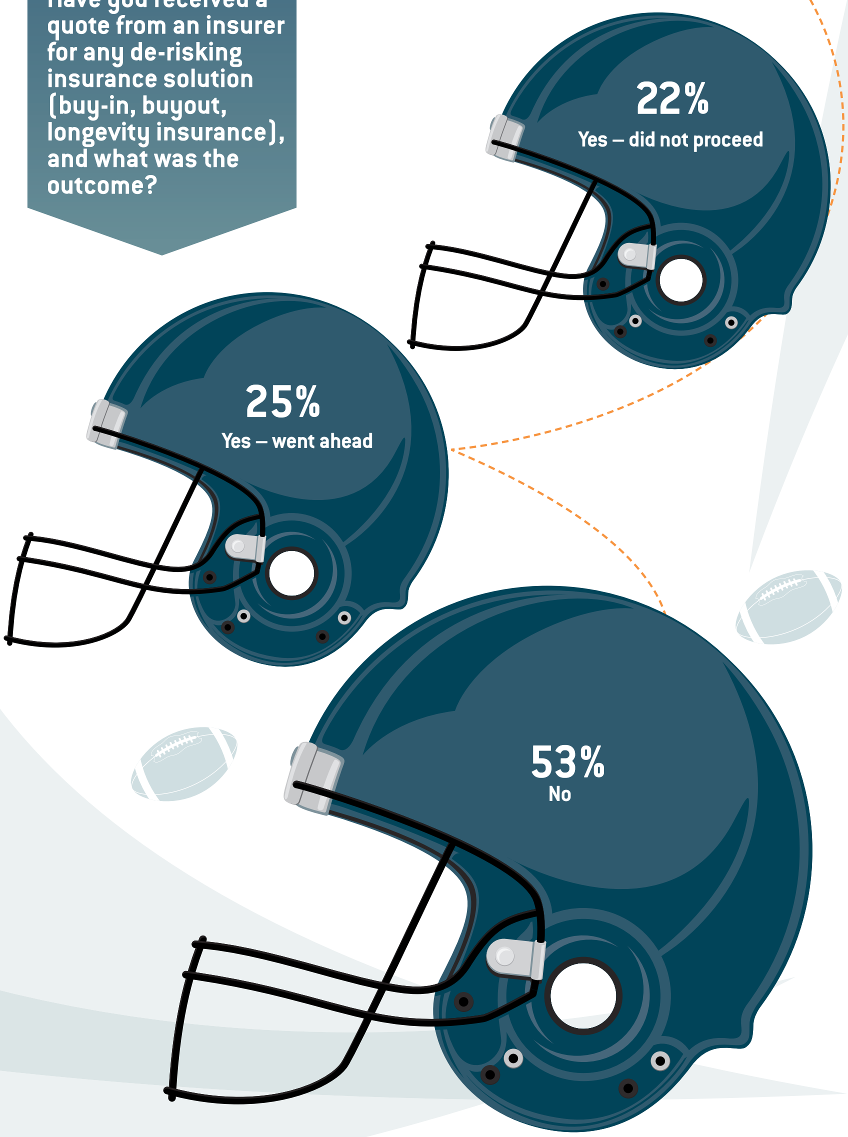
REMOVING RISK
The insurance solutions schemes are exploring to remove risk

EXPERT PANEL
A panel of three top consultants share their experiences

LEGAL VIEW
Get a legal perspective on de-risking challenges

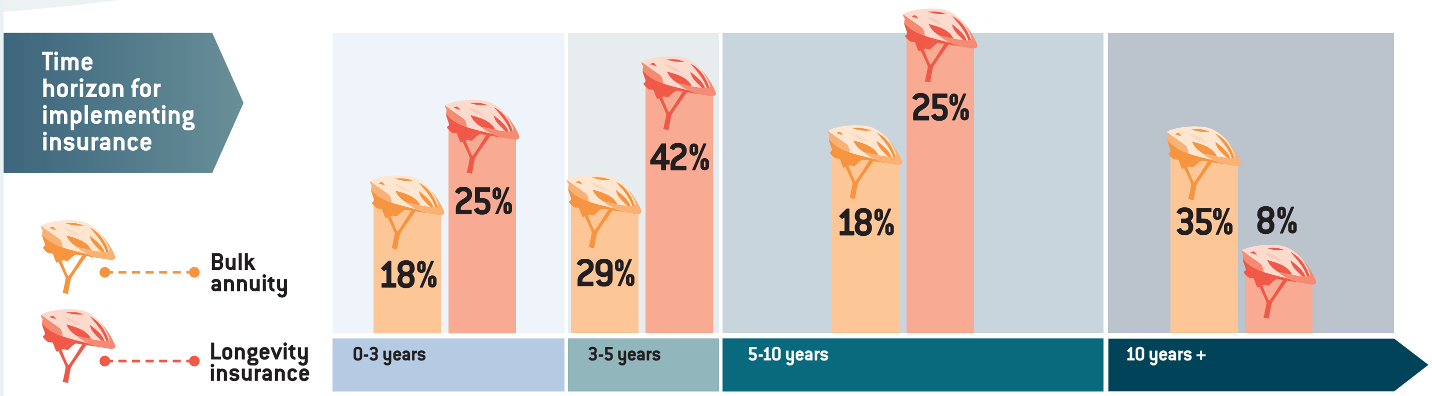
IN NUMBERS

Have you received a quote from an insurer for any de-risking insurance solution (buy-in, buyout, longevity insurance), and what was the outcome?



"Many years of journey planning are culminating in an increasing number of schemes looking to insure in the short to medium term"
Michael Abramson, head of strategic business
LEGAL & GENERAL

"The large transactions have created something of a stimulus"
Ian Aley, senior consultant,
TOWERS WATSON



INSURANCE MOVES CENTRE STAGE

Large schemes are already thinking about their de-risking strategies and have begun to use insurance solutions to help them along their way. Survey respondents were asked what they had achieved so far, and what their plans were. Laura MacPhee has collated the findings

Private sector schemes with more than £1bn in assets under management make up more than 60% of the defined benefit pensions universe, so any trends in their activities send out important signals about the general direction the market is heading.

In recent years there has been a significant uptick in their interest in insurance based de-risking.

By December 2014, the year-to-date total for bulk annuity business disclosed had reached about £12bn, up from £7.5bn from the whole of 2013.

The ICI Pension Fund broke a record by completing, at £3bn, the largest buy-in on record (see case study, p21).

BT Pension Scheme and the Aviva Staff Pension Scheme also made the headlines for their longevity hedging, which contributed to the total longevity hedging of £23bn in liabilities for 2014.

The figures are borne out by the survey findings among the £1bn-plus schemes. Almost half (47%) of the respondents had received a quote for insurance in the past, and more than half of those went ahead with their chosen insurer.

But these numbers pale in comparison to the volume of liabilities set to come to the market.

Two-thirds of schemes said they anticipated including insurance in their long-term objectives (as we discussed in the first chapter).

Of those that had not already implemented an insurance solution, two-thirds had not yet approached the market, and the 22% that did not proceed after receiving a quote still reported a wish to use insurance solutions in the future.

"In recent years there has been a significant uptick in interest in insurance based de-risking"

TIME HORIZONS

We wanted to have a better idea of the volumes we could expect to see coming into the bulk annuity and longevity insurance markets, and when we could expect schemes to start entering them.

It is fair to say these volumes will be increasingly significant over the next ten years.

Time horizons were generally shorter for longevity insurance, with a quarter of interested schemes looking to go down that route within the next three years, and a further 42% anticipating exploring that option within the next five years.

Buy-in and buyout were equally popular objectives for schemes, with around one half of interested schemes looking to »

» SELECTING THE RIGHT INSURANCE PROVIDER

Now that we have established that schemes have the will to implement insurance-based de-risking solutions, we can turn our attention to how they might achieve that.

The first question is: who will actually be driving the insurance exercise?

In the majority (63%) of cases it was a joint effort between the sponsoring employer and the trustee. In the few cases where it was more heavily led by one party; this was more likely to be the trustee (23%) than the sponsoring employer (14%).

Financial strength was a critical factor for schemes looking to choose an insurance provider – almost two-thirds (60%) ranked this as the most important criterion.

Almost twice as many schemes chose financial strength as their most important factor as those who said price was the crucial element (33%).

This is understandable since "normally the scheme would think about which insurers they are prepared to do a transaction with on a number of measures, including financial strength before they access the market for pricing," says Ian Aley, a senior consultant at Towers Watson.

Financial strength was a critical factor for schemes looking to choose an insurance provider

"If an insurer doesn't reach a certain hygiene level of financial strength, the pension scheme typically won't even ask them to quote. Of those insurers they're comfortable with, price clearly is an important feature as well."

If financial strength is so important to beginning the journey towards insurance, this begs the question of how schemes can actually judge that.

One measure is a financial strength credit rating, but some insurers do not have a credit rating. "It's a guide, but it can't be the only measure one would use," says Aley.

Insurers are obliged to hold a level of regulatory capital, and to report their solvency level on an annual basis. "That gives you a very good guide as to the relative strength of one insurer to another," Aley adds.

"The higher their capital ratio – the amount of capital in relation to the amount of capital the regulator asks them to hold – the more assets they have to cover their liabilities over and above the regulatory requirement."

PRICE

Although price was not the number one factor for most schemes, it would be naive to suggest that it isn't an important one in the decision-making process.

Schemes preparing to de-risk by going through a buy-in en route to a full buyout need to be aware that this is a dynamic process, and it will not be possible to know immediately exactly what it is going to cost.

You will typically only be able to firm up the price once you have done the initial deal.

There is then a period of between a few months and a year when the insurer verifies all the benefits, and goes through all the member information in some detail.

The data and benefits are firmed up more exactly when the scheme is ready to go to buyout, when a balancing premium will be paid, and may be from scheme to insurer or vice versa.

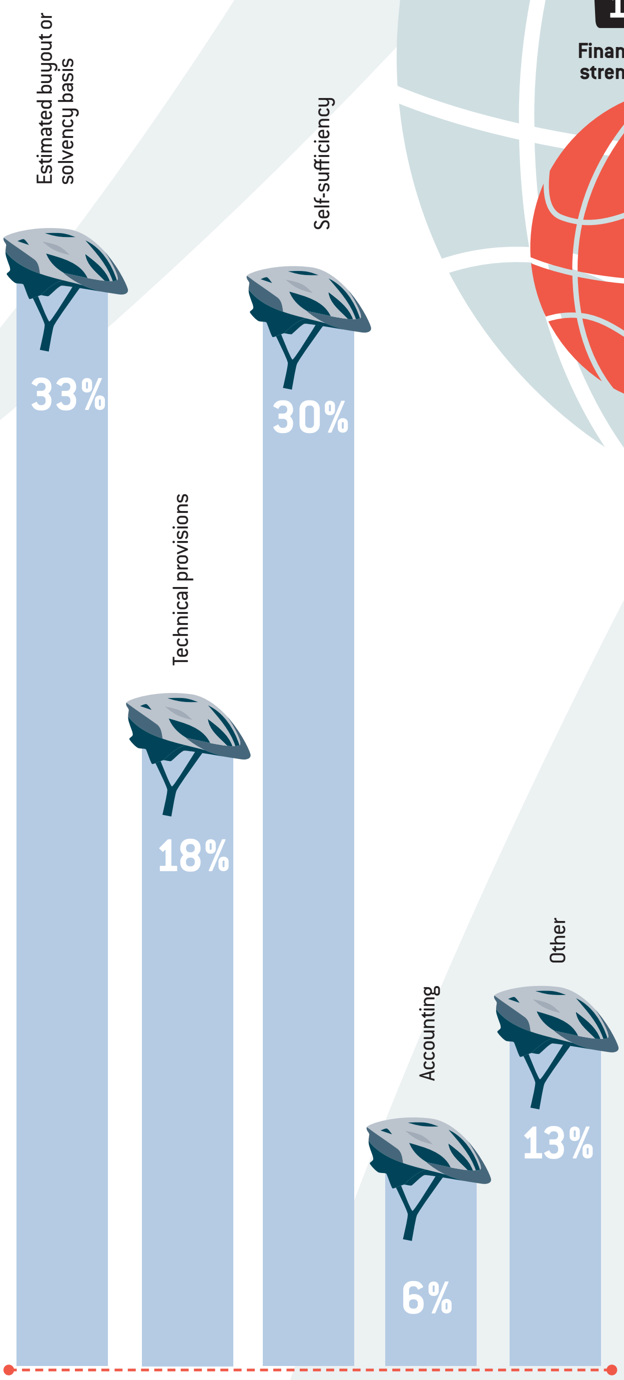
Trustees and their sponsoring employers need to think about the future and recognise that they don't get a firm price on one single day, and they can't get a price in advance, so they are committing to a process and a relationship with the insurer.

"It's crucial to ensure that the trustees are getting as much protection and as much flexibility as they can about the way things are going to play out on that journey to buyout," says Anna Rogers, a partner at law firm Mayer Brown.

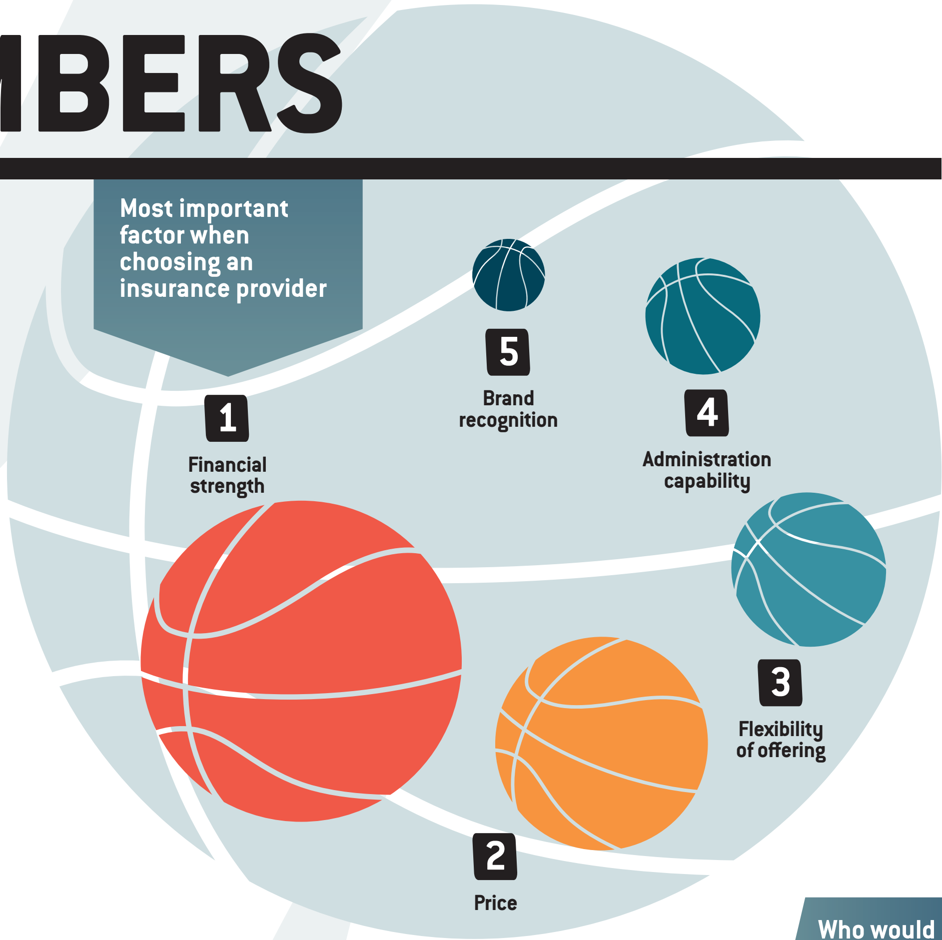
This means, she says, that they avoid any "nasty surprises about top-up premiums, and also once they have completed the buyout that's it – it's a clean break, and they're fully protected from any future exposure »

IN NUMBERS

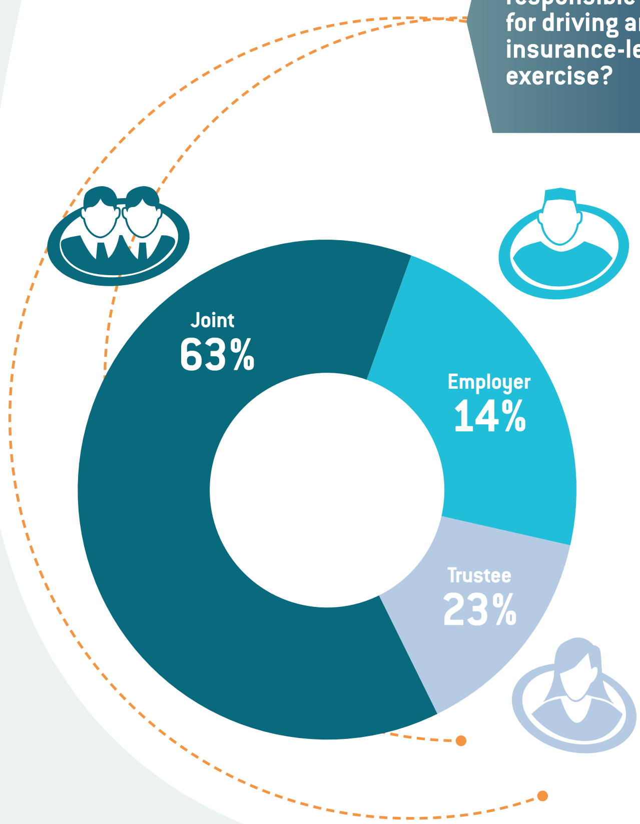
On what basis would you evaluate whether insurance pricing represents good value?



Most important factor when choosing an insurance provider



Who would be responsible for driving an insurance-led exercise?



» ASSESSING PRICING

Schemes were asked on what basis they were evaluating that cost. A third said that it was the estimated buyout or insolvency basis, and 30% judged it against self-sufficiency.

There was evidence that schemes recognised that there was a premium to pay for a risk transfer versus other liability measures, such as technical provisions (18%) and accounting (6%).

This premium reflects the additional security and certainty provided by an insurance policy.

NON-STANDARD INSURANCE SOLUTIONS

Going beyond the traditional bulk annuities and longevity hedging there are certain other types of insurance solution that schemes can employ to help take various risks off the table.

The first is a buy-in with the deferral of a premium payment – where the employer can negotiate with the insurer to agree a later date when they pay the premium, meaning the scheme doesn't necessarily have to have the full sum up front.

Just over a fifth (21%) of the schemes surveyed expressed an interest in this option.

Another non-standard solution that attracted interest from 19% of schemes was an all-risk buyout where the insurer takes on risks typically associated with run-off insurance.

All-risk buyouts are so called because they cover more risks than the standard longevity and investment risk and will cover the risk of incorrect data and errors with benefits, in exchange for a premium that will reflect the quality of the existing data and benefits calculations.

Schemes are likely to consider an all-risk transaction if they want certainty over future costs, or have a very short time horizon to complete a buyout and wind-up, for example in the case of sponsor insolvency.

There was evidence that schemes recognised that there was a premium to pay for a risk transfer versus other liability measures

PARTIAL BUYOUTS

TRW Automotive recently did a £2.5bn partial buyout, which is attracting attention throughout the pensions world.

However, there is some debate as to how that actually works – some deny that you can have a partial buyout, and that you need to insure the whole scheme, but others, including Legal & General, think this is an option that schemes will increasingly want to pursue.

This raises legal questions as to how a partial buyout would actually be feasible. Trustees and sponsors want to know if there is a way they can reach buyout for their current pensioners and then carry on with a smaller scheme for their deferred and active population.

"To buy out pensioners only you really need to split the scheme into two," says Rogers.

"You need to de-merge it, set up a new scheme, move your deferred and active members, leaving the pensioners with the bulk annuity in the original scheme that you then terminate."

THE RISK OF RUNNING OUT OF STEAM

Schemes exploring de-risking using insurance solutions need to make sure they are serious and prepared before they go out to the market. In the previous chapter we explored the various ways in which schemes can get themselves ready by cleaning up their data and transitioning their assets into the most convenient form.

The reason why this is so important is that insurers only have limited resources to spend on considering these deals, particularly if the scheme is very large and will require more work and incur higher costs. »

LONGEVITY INSURANCE – ASSESSING THE OPTIONS

Dominic Carpenter, head of structuring for Legal & General's bulk annuities and longevity insurance business explains the different choices available to larger pension schemes looking to insure longevity risk

Dominic Carpenter
head of structuring,
bulk annuities and longevity insurance,
Legal & General

The scheme benefits from the experience and expertise of the insurer... meaning the contract will facilitate future de-risking

This past year or so has seen interest in longevity risk management pick up pace, due to a number of ground-breaking arrangements. These have caught the eye of the industry due to their size, such as 2013's £3.2bn arrangement between Legal & General and the BAE Systems 2000 Pension Plan, the largest of its kind, at the time.

Some more recent arrangements have also been noteworthy, both due to their size and also through the use of alternative structures. For example, the Aviva Staff Pension Scheme completed a £5bn longevity arrangement in March 2014 via a sponsor owned insurance company to access the reinsurance market.

While Aviva was already very familiar with running insurance companies, the BT Pension Scheme took the step of setting up its own insurance company and passed £16bn worth of longevity risk through this to the reinsurance market in July 2014.

These landmark arrangements represent the options large pension schemes have when looking to insure – or reinsure – longevity risk.

INTERMEDIATED SOLUTION

The BAE transaction is an example of the most common form of longevity hedging to date, the intermediated solution.

This is when the pension scheme enters into a contract with an established insurer, and the insurer in turn enters into contracts with one or more reinsurers, depending on the transaction size, pricing and reinsurer capacity.

Under this approach the pension scheme benefits from having an arrangement with a UK-based insurance company, which is subject to UK rules and therefore comes with protection from the Financial Services Compensation Scheme. The insurer takes on the credit risk of the reinsurer and accepts the administration costs and the risk of these increasing in future.

The main benefit of this type of transaction for the pension scheme is that it is so straightforward, having just one contract with the insurer, regardless of how many reinsurers there might be, and the insurer takes care of the rest. The scheme also benefits from the experience and expertise of the insurer, having put together these types of deals many times before, meaning that the contract will facilitate future de-risking through a buy-in or buyout.

PASS THROUGH SOLUTION

The second option could be dubbed the pass through solution. This is where the pension scheme accepts terms directly with reinsurers, but there is an insurance vehicle to help facilitate this. However, none of the longevity risk sits with the insurance vehicle as it is all accepted by reinsurers.

This approach allows the scheme to benefit from some cost savings although the scheme will typically take on the reinsurer credit risk itself and enter into negotiations with reinsurers itself. Although insurers, such as Legal & General, are able to provide support with this approach, if required. Finally, if there is more than one reinsurer, the scheme must have multiple agreements and so the differences with the intermediated approach must be weighed up against any cost savings.

Legal & General has the capabilities to provide an intermediated or pass through solution. The former is tried and tested with Legal & General having implemented four arrangements covering almost £6bn of liabilities in this way. Its pass through solution would be based in Bermuda using a type of structure which has been commonly used in the insurance market for many years. This means that trustees can be confident of the robustness of the structure, whichever option they choose and can implement the structure most suitable for their scheme.

It is no surprise that almost a fifth of larger schemes are considering longevity insurance as part of their de-risking journey and we expect a range of approaches to continue to be used in future.

» Neil Bowden, a partner at law firm Allen & Overy, says: "They have to pick the scheme they think is serious, because they don't want to spend hundreds and thousands of pounds on legal and actuarial fees, pricing a deal and thinking they're going to do a deal, only to find this big roadblock: that some trustees hadn't realised there were big problems with their scheme.

"If you have an abortive process whereby you start something and it runs out of steam, you may find it's difficult to attract insurers' attention at some later point when you are actually in a position to do it."

WHERE IS THE MARKET HEADING?

There is likely to be continued interest in buy-ins, buyouts, and longevity hedging.

Towers Watson's Aley says: "In 2014 there have been some large transactions in that space, which has created something of a stimulus."

The conditions in today's market are similar to those that existed in 2007 and 2008 when the market was starting to take off, and jumped to £3bn from its 2006 figure of £1bn.

"You had increasing demands from pension schemes because the cost of alternatives was increasing, and therefore the marginal cost to do insurance was smaller," says Tom Seecharan, a director at KPMG.

"You had lots of insurers coming into the market wanting to get transactions done, as you do today."

Two new insurers have come into market in the past year, and at least three more are expected in the next six months. He adds: "You've got increasing demand from schemes, increasing supply from insurers, and you've got good market conditions to go alongside that."

Schemes transacting now will also stand to benefit from the innovation that has been taking place to help make transactions more efficient – processes have been streamlined and providers and consultants have increased knowledge and experience.

Seecharan says: "All of that puts the market in a fundamentally better place to grow when conditions are good."

64%

of schemes plan to implement buy-in, buyout, or longevity insurance

47%

of interested schemes plan to implement bulk annuities in the next 5 years

60%

of schemes said financial strength was the most important quality in an insurer

63%

said the insurance decision was made jointly between the trustees and employer

22%

received a quote from an insurer but did not proceed

LEARNING FROM EXPERIENCE

Our panel of consultants advise some of the largest schemes in the UK on their de-risking transactions. Laura MacPhee spoke to three experienced industry experts – David Ellis, head of bulk pensions services and wind-up, Mercer; Emma Watkins, partner, LCP; and Martin Bird, senior partner, Aon Hewitt

David Ellis
head, bulk pensions and wind-up
MERCER

Emma Watkins
partner
LCP

Martin Bird
senior partner
Aon Hewitt

"The pensioner doesn't care if they're in a £10m scheme or if they're in a £1bn one. They just want their pension to be right and to be paid for life"

Are £1bn-plus schemes interested in insurance-based solutions, and should they be?

All: Yes, they are interested.

Emma Watkins: I think it depends on the individual circumstances of the pension scheme. One scenario where they might be interested in buyout is where they've positioned their assets themselves into a portfolio that is pretty matching. In that case the move to buyout is much more affordable for them.

The other area where they might be looking at buyout as a real possibility is potentially where there's some kind of corporate activity, and so there's a real desire to take the pension scheme off the table because that might be more attractive in any kind of corporate activity.

Martin Bird: Typically buyouts, as opposed to buy-ins, have happened on sponsor insolvency where the trustees have been forced to wind up the trust and secure benefits with an insurer and the reason has largely been in those cases because the trustee has no other option than to do that.

What we've seen in the marketplace is more of a focus on buy-in because it has generally been pensioner blocks that have bought in because the scheme or sponsor hasn't been able to afford the premium for a complete buyout.

David Ellis: Transactions like the TRW Automotive case are lighting the way for others. It gets to decision-makers at the real top of multi-nationals and they think: 'Yes, that makes sense. If they can make it work maybe we can too.'

Are there any specific issues which apply at the larger end of the market?

David Ellis: Yes. Let me compare and contrast. I do deals of all sizes. My team does plenty of £10m or £15m deals – completely the other end of the scale.

However, I must point out that regardless of the scheme's size the interest is again absolutely right because it's the individual members – possibly their entire livelihood – that's at stake. The pensioner doesn't care if they're in a £10m scheme or in a £1bn one. They just want their pension to be right and to be paid for life.

We're always bearing that in mind, but it does feel like pensions work at the smaller end of the scale, where it's a pensions deal, and it's just a scheme with pensions advisers working on it, and it still feels more like business as usual with the insurers. There's more standardisation and less flexibility.

You go above £1bn and it's more like a corporate divestiture. This is basically M&A in many ways. No business counter-party – in this case they're insurers – takes on [more than £1bn] of irreversible liabilities lightly, given that they're going to have to pay these cashflows for the best part of a century. »

» **Emma Watkins:** It's probably too simple an answer to it, but in honesty the size of the company's balance sheet versus the pension scheme is a more important factor.

Where you've got large schemes it's likely that they're going to be a large proportion of the company's wealth, whereas you've got a number of small schemes out there who potentially have large employers – therefore their ability to write a cheque to move it to buyout is much easier.

How can schemes really prepare themselves for a transaction?

Martin Bird: How you think economically about getting the deal done in a way that maximises members' benefits I think would be a priority for trustees.

Trustees should make some kind of agreement as to price tracking and at what level they're going to be ready to pull the trigger.

It's a lot of work to put £1bn worth of annuity together – that's not something that you can just have a look at and casually do overnight. So it's the whole governance around that project – what they're looking to achieve, timescales, getting all the people that have an influence on the decision around that, and just getting some really strong project governance in place.

Emma Watkins: Monitor, look at your data, look at your benefits, set up your governance structure, liaise with the corporate about the end goal. They probably are talking on a regular basis with the corporate.

They will be looking at the covenant strength of the employer. They will be putting that into the decisions they make every day.

So if it hasn't been had already, having a very upfront conversation with the corporate, and arguably with the parent company – particularly if it's an overseas company – about where they see the end game for that pension scheme.

Buyout is probably on everyone's radar, but for the corporate is that two years away? Is that five years away? Is it 20 years? Are they happy with the longevity risk that they have?

Martin Bird: Make sure you've got a data pack that you can transact on. That is just good housekeeping anyway, but what the transaction does is give you a bit of momentum to try and focus some of that work.

GMP (guaranteed minimum pension) equalisation is a big issue at the moment. Obviously there's a window when schemes can do that, so it's about thinking and getting the strategy right around that.

Think about the asset strategy you're sitting on. If you transition assets that an insurer doesn't want and they have to disinvest then re-invest those, then you generate a lot of transition costs, which at the margins can add up to substantial amounts of money.

"Nobody does it lightly. Who'd give £1bn to somebody else lightly, when you can never get it back?"

Where do you see the market heading over the next 12 months?

David Ellis: I think there will be other large transactions. Nobody does it lightly. Who'd give £1bn to somebody else lightly, when you can never get it back? Rightly so.

But there will be other trades – it is moving that way. Companies are seeing that interest rates are stubbornly low – maybe you can do it cheaper in five years' time, but if you insure it now then you know where you stand.

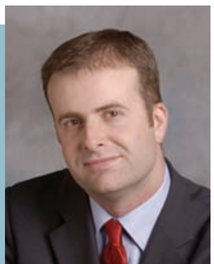
Emma Watkins: The first strand would be capacity. We saw the Budget in 2014 had a massive impact on the retail annuity market. That means that multi-line insurers already active in the annuity market potentially have additional capacity that they can now focus on the bulk annuity market.

In my view many of them are doing that, so we've seen record levels of insurer capacity for deals in 2014 and we can expect that to continue into 2015.

Perhaps in the latter half of 2015 I would expect to see some new entrants, existing insurers but new entrants coming to market, and therefore being able to provide more capacity and continuing to drive competitive pricing.

A LEGAL PERSPECTIVE

Laura MacPhee speaks to Hywel Robinson, a partner at law firm Clifford Chance about the legal, commercial and practical questions schemes are asking when considering insurance solutions - from who should be advising them to timescales and systemic issues with data



Hywel Robinson
partner
Clifford Chance

Laura MacPhee (LM): Do you think there are any legal issues relating to large schemes in terms of buy-ins or buyouts?

Hywel Robinson (HR): One thing that I always think is worth thinking through is that sometimes larger schemes find that they want to use multiple providers. Often they are too big to insure all the liabilities that they want to insure with a single provider, and they might want to go with multiple insurance companies.

That raises its own types of issue. How do trustees decide who goes where, for example? Who should be insured with a particular provider, who should go with another provider? Is it fair to put particular people with particular companies? It's not a difficult issue to overcome legally, but it's an important process for trustees to go through.

Other than that I think fundamentally the legal issues that go into a buy-in or buyout are the same for a small buy-in or buyout as for a large buy-in or buyout. I guess towards the larger end buy-ins and buyouts tend to bring in more complicated features. When insurance companies are dealing with a large pension scheme, the trustees may have more leverage.

For example, some pension schemes want to take security, or collateral, when they're going through a buy-in process, and at the smaller end that doesn't usually happen. At the larger end collateral is more likely to be a feature. Other elements such as taking on data risk, for example, are more likely to be a feature of a large buy-in. Those aren't legal issues that are exclusive to a large buy-in – they're just more likely to be involved.

LM: Are there any key questions that larger schemes are asking, either legally, commercially or practically?

HR: I think one key question that larger schemes often find themselves asking is who should be advising them on a buy-in and buyout process. Smaller schemes tend to just use their existing advisors. Larger schemes tend to give a bit more thought to who they need to involve in this process.

Buy-ins and buyouts are quite a specialist area. Market knowledge can be very important and the sorts of people that pension trustees work with on a day to day basis won't necessarily have all that expertise.

The usual advisors may still have a role because scheme knowledge can be very important but you might want to bring in some extra people.

Legal advisors are always involved in buy-ins, but not all pension lawyers, for example, will be dealing with buy-ins and buyouts regularly, and some of them won't have much experience and sometimes the larger schemes do feel the need to bring in somebody extra.

This isn't specific to large schemes, but it's probably worth mentioning because it's such a large question in relation to all buy-ins and buyouts: what sort of shape is your data in?

A lot of pension schemes have quite big gaps in their data in terms of what benefits members are actually entitled to, and almost always in a buy-in or buyout those gaps need to be filled. If the gaps are large it can create a lot of »

» uncertainty in terms of what the final premium's going to be, and it can create a lot of delay as well, because the process of getting all the data can be really quite involved.

Sometimes it will go as far as a full audit. Sometimes it will be a case of looking at all the data and doing a full check as to whether that's right. More commonly it will involve looking for systematic issues with the data – to try and do what you sensibly can to improve it beforehand.

There's a related element which is that some insurers will actually take on that data risk. They charge extra for it, but sometimes you can pay them a premium and then they'll say "We'll take on the responsibility – if there are gaps in the data we'll fill them".

LM: How much of a premium would it be?

HR: It varies quite a lot from insurance company to insurance company. Before any insurance company will agree to do that they will want to do some diligence on the data themselves. If they think there aren't that many gaps then they might charge a relatively low premium. If they think there are major problems then frankly they might refuse to take on the data risk entirely. It varies quite a lot.

LM: What other issues have you seen from your clients?

HR: Timetable is quite an important question. A buy-in or buyout can be quite a long process. In a traditional buy-in you sign a contract and then you have a period of data verification. Often it will take a couple of years.

There's certainly been processes that have gone on for even longer and that's worth being prepared for. If particular schemes and particular employers have deadlines they need to work to there are ways of accelerating that process. Some of them come at a cost.

One thing that's a particularly live issue for some clients at the moment is about who's responsible for what. A buy-in is often a collaborative approach between all the different individual advisors, and I think it's very important to be very clear up front what the responsibilities are.

You do come across cases where you look further down the process and something hasn't been done as it should, and maybe it isn't entirely clear as to who was supposed to be doing it. Setting a clear project plan and setting out who is responsible for which elements of the project plan I think is a very important element.

"One thing that's a particularly live issue for some clients at the moment is about who's responsible for what"

LM: How do you see the buyout market developing over the next 12 months?

HR: There are going to be new entrants into the market, I think. There's been an uptick in the market over the past 10 years. There have been new entrants into the market and some of the more established players have really ramped things up as well.

I think some of those new players are likely to be trying to introduce new features into buy-ins, maybe ways of making them more realistic, or more affordable for some schemes.

I think we'll probably see an increase in all risk deals - where you pay the insurer extra, and they take all the liabilities. They don't just take what they know about. They agree to take all the liabilities of the scheme, whatever they may be – and that seems to be a growing area.

A lot of schemes have these large gaps in their data. Going down the traditional route can be quite a long and difficult process for them and maybe more of them are thinking that all risk is going to be worthwhile to do.

03

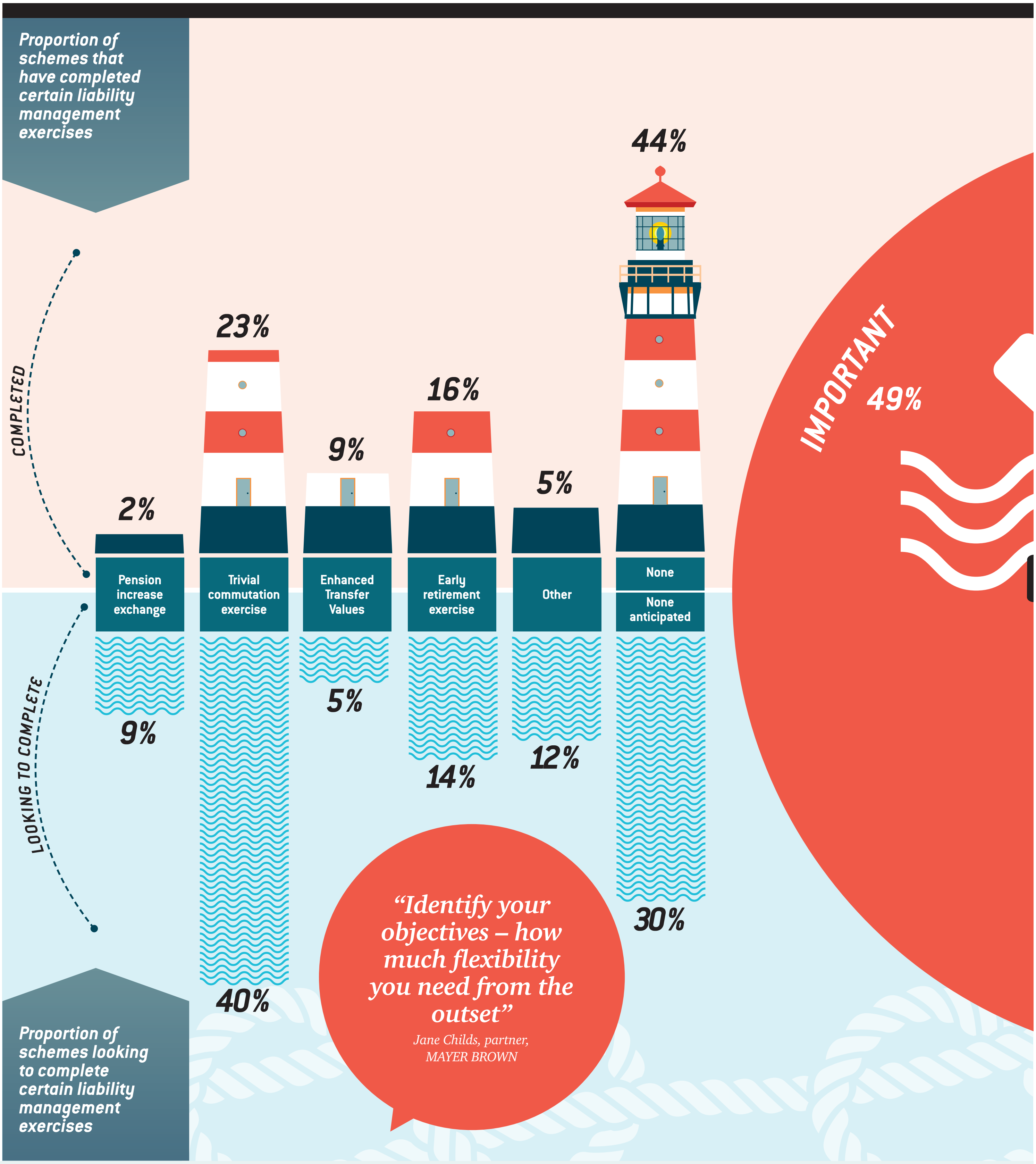
LIABILITY MANAGEMENT

LIGHTEN THE LOAD
How schemes are managing their liabilities to reach their goals

NEW FLEXIBILITIES
How the 2014 Budget is affecting scheme decisions

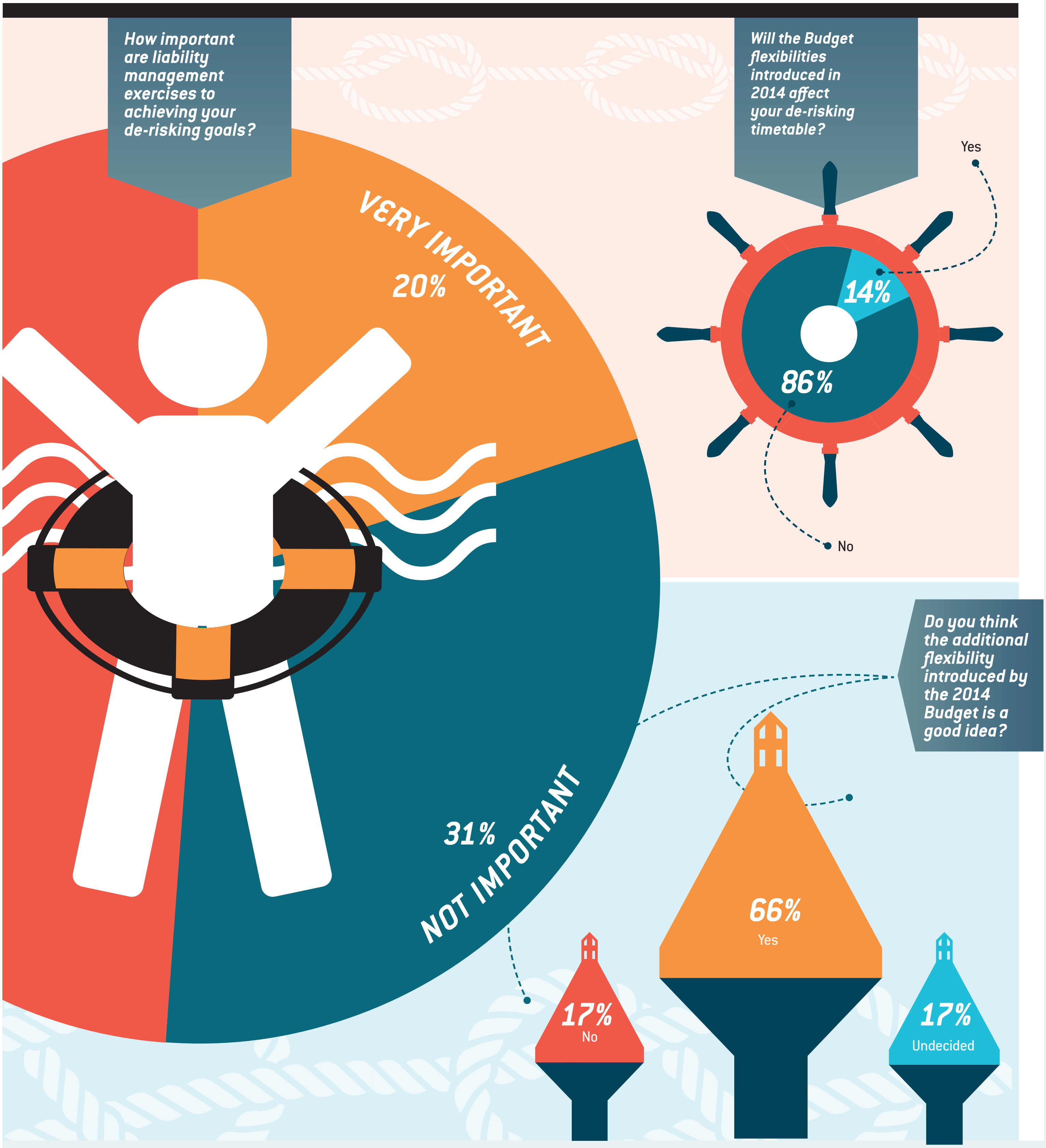
MAKING WAVES
Discover how TRW made headlines with its £2.5bn deal

IN NUMBERS



"Identify your objectives – how much flexibility you need from the outset"

Jane Childs, partner, MAYER BROWN


How important are liability management exercises to achieving your de-risking goals?
VERY IMPORTANT
20%
31%
NOT IMPORTANT
Will the Budget flexibilities introduced in 2014 affect your de-risking timetable?
Yes
14%
86%
No
Do you think the additional flexibility introduced by the 2014 Budget is a good idea?
66%
Yes
17%
No
17%
Undecided

TRW

INNOVATION LEADS TO A £2.5BN REDUCTION OF PENSIONER LIABILITIES

In November 2014 Legal & General and the TRW Pension Scheme announced the buyout of £2.5bn of the scheme's pension liabilities, the largest buyout in the UK to date and the most innovative arrangement of its kind.

"We started planning for this de-risking project in the summer of 2013 and engaged a number of consultancies and insurers about possible insurance solutions we could consider to develop our thinking. Ultimately, Legal & General was able to provide the flexibility we required to meet the different stakeholders' objectives", said Joel Griffin, UK pensions manager at TRW.

The journey began in late 2013, when TRW resolved to obtain a buyout for a portion of the scheme's pensioners, thereby significantly reducing the pension liability on the company's balance sheet, by year end 2014. The buyout was to be combined with a Pension Increase Exchange (PIE) offer which gave pensioners the option to trade their inflation-linked pension increases for a higher, non-increasing pension. Members were given three months to consider the PIE offer, engage with an independent financial advisor, paid for by the scheme trustee, and decide whether or not to accept the offer.

To give the pensioners greater clarity of the process, the PIE offer made it clear that those who accepted the PIE would also be guaranteed an annuity with Legal & General. It was expected that this would increase the level of engagement from members during the advice process. This feature created uncertainty in the arrangement as the ultimate size of the buyout would depend on member take up of the PIE option. The scheme and company wished to also have the option to insure members who did not accept the PIE, so the total size of the transaction could have been anything up to £2.5bn.

Given the length of the PIE offer window and the uncertainty around the number of pensioners that would ultimately be insured under the buyout, it was important for Legal & General to provide a transparent and robust method for the scheme to track the annuity price for each individual. In order to achieve this objective and to provide pricing certainty during the period between pricing being agreed and the buyout being secured, Legal & General developed a transparent mechanism whereby the price of the annuity tracked the value of a pre-defined list of assets.

TRW could easily verify changes in the annuity price by comparing the spread on the assets from one date to another. Furthermore, pricing certainty could be achieved for the scheme by purchasing the assets underlying the annuity price.

This price tracking approach was a pioneering aspect of the transaction which has never been done by any insurer in the UK or elsewhere. Mike Edwards, head of solutions at Legal & General said that "the price tracking mechanism was one of the key elements of the project. It gave the scheme and their advisers both certainty and transparency during the PIE offer period to enable them to assess the overall economics for the scheme and inform their decision making at the end of the process regarding the ultimate amount of liability to be bought out".

Ultimately 38% of members accepted the PIE offer and were therefore insured by Legal & General. Through an additional contribution from the company, the scheme was able to insure a large proportion of pensioners who had not accepted or been offered the PIE. This led to a larger than anticipated total transaction size of £2.5bn, the largest ever buyout in the UK.

A LITTLE EXERCISE CAN DO YOU GOOD

Liability management is crucial to effective de-risking – 69% of the schemes surveyed said it was either important or very important to meeting their objectives. There are a number of exercises that schemes can use to help them on their way

"Two thirds of schemes believed the new flexibilities introduced by the Chancellor in the Budget were a good idea in principle"

Schemes are already taking positive steps towards implementing a variety of strategies to manage their liabilities.

Almost a quarter (23%) in the survey said they had carried out a trivial commutation exercise (for a definition see box below), while 40% plan to in the future, making this the most popular course of action.

"The trivial commutation limit has obviously gone up," says Emma Watkins, a partner at LCP. She says that this means trustees should be asking themselves whether they ought to "be going out to those members who may now qualify for commutation, and making sure that they understand that's an option before they potentially go and insure those liabilities for them in an insurance company, only for them to take that trivial commutation at some stage in the future and induce this value leakage out of my insurance contract".

Schemes had also reduced their liabilities through offering lower early retirement benefits (16% had done so, and 14% had it in their plans), and enhanced transfer value (ETV) and pension increase exchange (PIE) exercises.

In an ETV exercise the employer offers the member the option to transfer their accrued pension from the defined benefit scheme to a personal pension, allowing the member to access increased flexibility.

The transfer is enhanced because the employer will typically offer the member more than the trustee would usually pay for a transfer value.

In a PIE exercise the member agrees to accept a flat rate of annual retirement income rather than receiving an annual increase in line with inflation. This offer can be attractive because the flat rate will be higher than the member would otherwise have received in the early years.

An industry code of practice was launched in 2012, which sets out guidance to schemes on how these exercises should be run.

TRIVIAL COMMUTATION

The process whereby a member of a pension scheme chooses to take his or her pension entitlement as a cash lump sum.

'Trivial' indicates that the pension pot is relatively small – following the 2014 Budget changes this sum is capped at £30,000.

A PIE EXERCISE

The TRW Automotive scheme recently made de-risking history with its £2.5bn partial buyout. A PIE exercise formed a very important part of this process, and that is one reason why this transaction was so innovative.

The scheme wrote to all its pensioners saying that if they took up a pension increase »

» exchange their benefits would be insured with Legal & General, and 38% took up this offer.

The insurer gave the scheme a price that would cover any number of members, and unusually was able to sign the contract without knowing the exact figure, to enable the scheme to go out to its membership and make the PIE offer which helped make the transaction affordable (see p 38 for a full case study).

The critical point was that TRW Automotive had engaged the insurer throughout the whole process and discussed the options available for carrying out a PIE exercise as part of the journey to buyout.

There has been another case where the employer decided it wanted to have the option to run a PIE exercise relatively late in the tendering process. The insurer agreed, on the condition that they could have a wide-ranging indemnity, which ultimately proved unacceptable to the trustees.

This example illustrates two fundamental points. Jane Childs, a partner at law firm Mayer Brown spells them out: "One: identifying your objectives – how much flexibility you need from the outset, and two: actively engaging with the employer, and getting a commitment to what the scope of this transaction will be from an early stage."

"Where schemes are looking to do something different we would always encourage them to engage insurers early in their thinking to avoid wasted time and fees," adds Mike Edwards, head of solutions in Legal & General's bulk annuities practice. "We can help them shape their solution into something workable for all stakeholders, as was the case with TRW".

THE BUDGET

Chancellor of the Exchequer George Osborne shook the pensions industry with his 2014 Budget announcements, and the repercussions will continue to be felt for some time.

One of the survey respondents summed it up as: "Good for defined contribution members, not as clear cut for defined benefit."

Although the reforms will indeed affect DC schemes most directly, it would be unwise for DB trustees to ignore them as they could have implications for their members.

One question trustees on any large scheme need to ask themselves is: "Have I looked at what flexibilities the Budget is bringing in, and have I made sure I've explored those possibilities with my members before I've approached the market?"

"There's optionality a DB scheme might want in terms of making sure that nothing would prevent members transferring out if you agree a buy-in first," says Allen & Overy partner Neil Bowden.

Only 14% of respondents said that the Budget would have an impact on their de-risking timetable

Only 14% of survey respondents said the Budget would have an impact on their de-risking timetable, with most expecting that it would shorten their time horizon.

The Budget reforms have made liability management exercises such as trivial commutation and transfer values more attractive to members because they have more flexibility to take more of their pensions as cash.

This could improve scheme funding levels to the point where insurance becomes more affordable.

Two thirds of schemes believed the new flexibilities introduced by the chancellor were a good idea in principle, but several expressed reservations about how well equipped their members were to make the relevant decisions.

"In principle this freedom is a good thing," said one respondent. "However, we are concerned that members are unprepared to take advantage of these freedoms, and the market is unable yet to provide appropriate and cost-effective delivery platforms."

"The need for good advice is a key concern," agreed another, while a third went on to elaborate that he did not believe "there is a common appreciation of the size of pensions assets necessary to produce an acceptable pensions income".

INNOVATING TO MAKE DE-RISKING EASIER

Mike Edwards, head of solutions for Legal & General's bulk annuities and longevity insurance business discusses innovation in the insurance de-risking market for larger schemes and emerging trends

Mike Edwards
head of solutions,
bulk annuities and
longevity insurance,
Legal & General

The needs of schemes of all sizes can often be met with a traditional "journey plan" approach culminating in a full buyout or self-sufficiency, possibly incorporating a buy-in or longevity insurance. For larger schemes, where the situation is often more complex or where there is a desire to remove risk quickly, insurers must be flexible and innovate to help them de-risk.

Legal & General's ground-breaking £2.5bn partial buyout with the TRW Pension Scheme, which incorporated a Pension Increase Exchange (PIE) exercise, demonstrates our ability to provide innovative solutions which meet the needs of larger pension schemes. There are a number of areas in which we expect to see more development in the short term to help schemes meet their objectives more easily.

THE RISE OF DEFERRED PREMIUM FACILITIES

It is interesting to see that around a fifth of the schemes surveyed would consider a deferred premium approach to financing insurance. While this approach has largely been the preserve of small schemes so far, we expect that it will become more commonplace as funding levels improve, as the payment structure can be flexed to correspond to the employer's recovery plan – up to ten years in some cases. The approach gives certainty to trustees, as 100% of benefits are insured at outset, and to employers, as there is no need to increase contributions and no risk of additional contributions being required in future. The research also shows that nearly half of the schemes who were planning on purchasing a bulk annuity would do so in the next five years –a deferred premium facility could likely help many of these do it sooner.

USING DIGITAL PLATFORMS TO ACCESS OPPORTUNITIES

Consultants and insurers are increasingly focussing on the use of online systems to provide schemes with insurance cost estimates and to track this over time. Availability of ongoing pricing has several benefits – it gives schemes greater confidence to initiate a formal quotation process and helps to identify periods where affordability is greatest.

Implementation processes are improving all the time too, so in future schemes should be able to transition to the insured environment seamlessly as and when market opportunities arise, using trigger-based techniques like those which have been applied in investment markets. The research results suggests that only around one fifth of large schemes currently track the cost of insurance using online systems, so use is likely to increase dramatically.

LIABILITY MANAGEMENT EXERCISES

It is no surprise to see that 70% of schemes consider liability management exercises as important to achieving their de-risking goals. Liability management can reduce risk, improve funding levels and provide members with genuine benefit flexibility. Since the 2014 Budget, schemes are increasingly revisiting the decision to carry out liability management exercises. The code of good practice ensures these are conducted appropriately.

While liability management exercises can have benefits, schemes should be aware of two key factors if insurance is their ultimate aim:

- Market risk: If insurance terms are not agreed prior to carrying out an exercise the scheme's de-risking time horizon may be extended. Also, any savings arising from the liability management could be eroded by changes in market conditions.
- An insurer's view of the exercise: Liability management exercises introduce additional risks to insurers, for example reputational and selection risks, which need to be addressed or factored into the pricing. If an exercise is carried out which targets a particular group of members, for example those in poor health, then this is likely to alarm insurers when asked to provide a quote due to potential selection concerns. This could result in higher pricing or insurers even being unwilling to quote.

Legal & General's ground-breaking £2.5bn partial buyout with the TRW Pension Scheme demonstrates our ability to provide innovative solutions

SETTING NEW RECORDS

Laura MacPhee interviews James Mullins, a partner and head of Hymans Robertson's buyout solutions team, who was involved with Aviva's £5bn longevity insurance

James Mullins
partner
Hymans Robertson's
buyout solutions team

What approach are large schemes taking to manage risk?
I think large schemes take risk management very seriously. Risk management can take different forms, but I think transferring risk to insurance companies is becoming more and more popular for larger schemes, and I think that trend will continue.

Over the last couple of years we've seen records set for the size of buy-ins and buyouts for larger schemes. We had TRW that we were involved with towards the end of the year, and ICI earlier in the year. I think that trend will continue. I think we'll see more records broken for large deals and I think they should be.

Large schemes certainly need to manage risk and I think insurance provides a great way of managing that risk. Insurance companies have massive economies of scale, so they are able to manage liabilities and risks in an efficient way, which I think represents good value for pension schemes.

How are large schemes tackling longevity risk?
Longevity hedging was obviously particularly popular for large schemes, so that's a key one for the size of schemes you're surveying. That's where you hedge the longevity risk in isolation, and I think that works best for larger schemes because you need a certain size to manage the contracts and to manage the scheme for a longer period.

I think schemes that go down the longevity hedging route are more likely to take the view that they're going to try and manage the scheme in house by buying various products to help manage risk. But fundamentally they're looking to manage the scheme themselves, so that requires a bit more resource, and that tends to work better for larger schemes.

The other variation we've seen just recently, and I think we'll see a bit more of, is medically underwritten buy-ins, which have grown in size and popularity over the last year. I think you'll see more large schemes make use of those – not to transfer risk for the large part of the scheme, but maybe a small select part of their scheme could be insured with a medically underwritten buy-in.

What about investment risk?
If you do a longevity swap then that tackles your life expectancy risk, and the other part that you need to focus on then is the investment risk. I guess larger schemes are getting more and more sophisticated about how they hedge financial risk, investment risk, so are buying investments that carefully match the cash flows that they are then committed to pay.

Liability driven investment is still on the increase. Large schemes are trying to find other assets which match their cash flows but perhaps deliver some slightly higher returns – especially in the short term.

How has the insurance market changed?
I think if you go back five years the largest buy-in or buyout was £1.1bn. You did hear people say "Well, large schemes don't have the option of doing a buy-in or buyout because that size of deal hasn't been done yet. So therefore that's not an option for larger schemes".

Now we've seen quite a few deals well above £1bn – multi billion pounds deals. I think insurers now have appetite to take on very large deals.

There's no boundary really in terms of the size of transaction that you can complete. It just requires a bit more management.

04

RISK ASSESSMENT

MEASURING RISK
How schemes are monitoring the risks they face

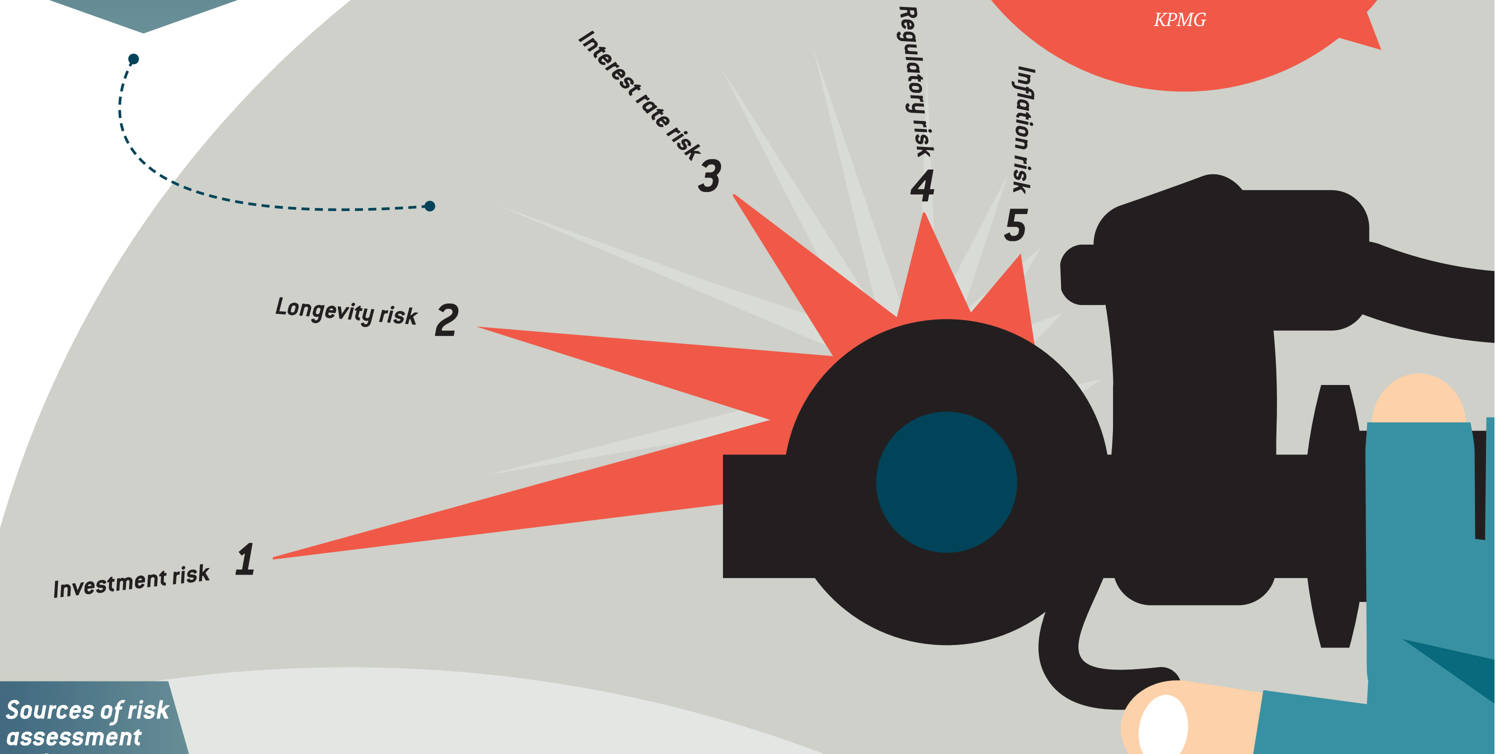
PRICE MATTERS
Expert guidance on how recent buy-ins have been priced

CASE STUDY
How the Merchant Navy Officers Pension Fund took the risk out of its scheme

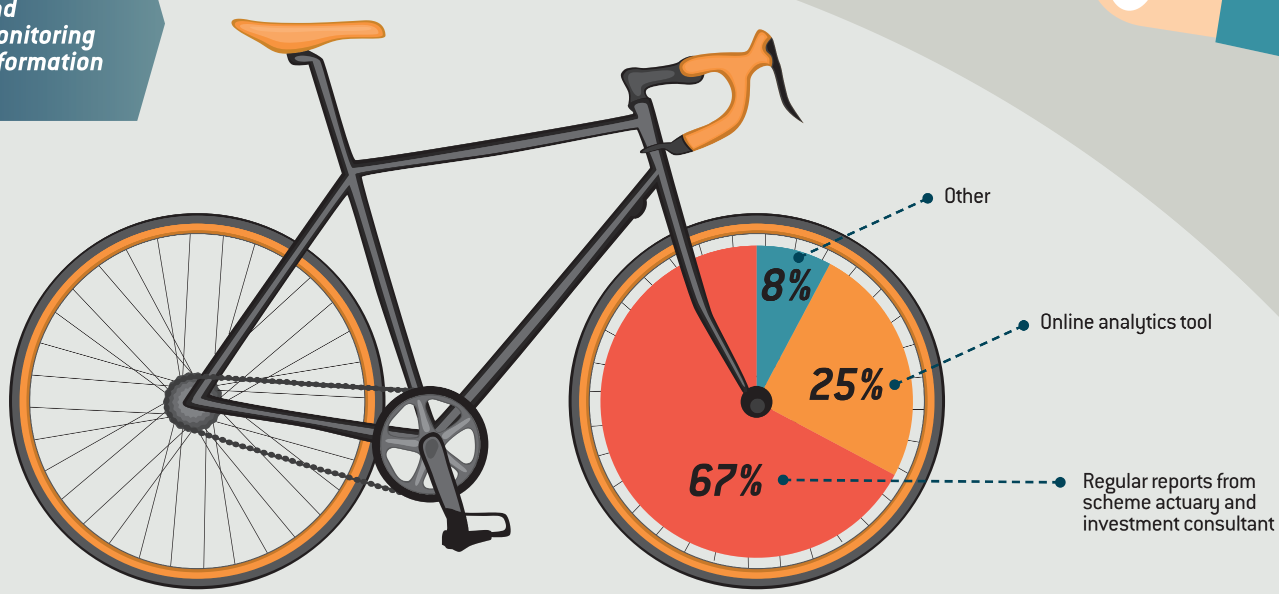
IN NUMBERS

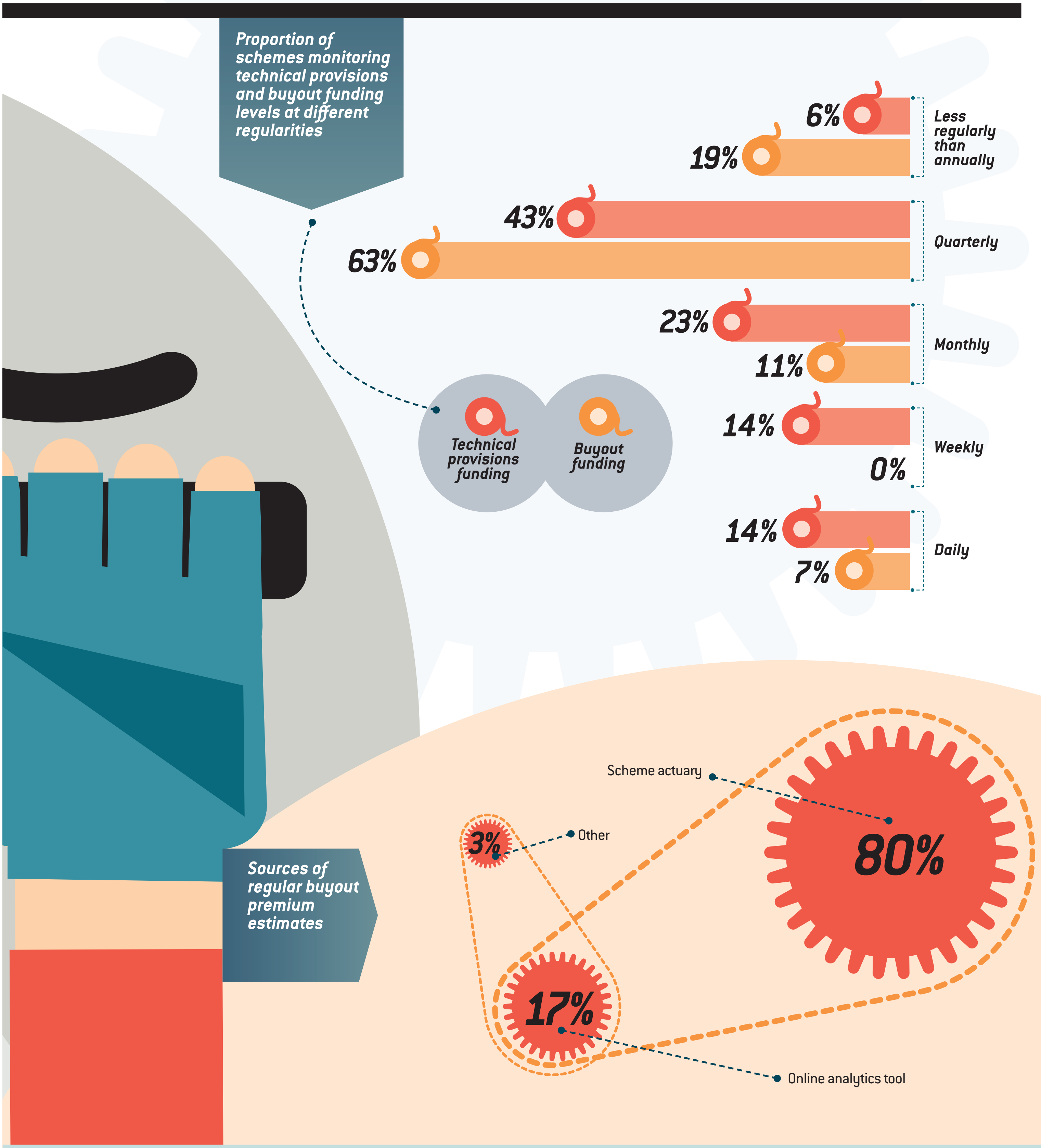
> *"Once you're fully de-risked on the investment side, what's left is your demographic, and in particular your mortality and longevity risk"*
>
> *Tom Seecharan, KPMG*

What is the most important risk facing your pension scheme?



Sources of risk assessment and monitoring information




Proportion of schemes monitoring technical provisions and buyout funding levels at different regularities
Technical provisions funding
Buyout funding
Less regularly than annually
6%
19%
Quarterly
43%
63%
Monthly
23%
11%
Weekly
14%
0%
Daily
14%
7%
Sources of regular buyout premium estimates
Scheme actuary
80%
Other
3%
17%
Online analytics tool

THE BIGGEST RISK

When schemes talk about de-risking, which risks do they really mean? Survey respondents were asked the biggest risks they face and how they monitor and mitigate them

It is all very well for schemes to say they are de-risking but it makes little sense to begin a process without considering which risks you are trying to remove.

Trustees were asked what they thought the biggest risk facing their scheme was, and 41% said it was investment risk, while a quarter cited longevity risk. Insurance solutions can remove both risks because once members have been bought in or out they are no longer subject to the volatility of investment strategies, and they will be covered for the rest of their lives.

"For most pension schemes it starts with investment de-risking, because most of the real risks that can hit you day to day are on the investment side," says Tom Seecharan, a director at KPMG.

"Traditional theory would say once you're fully de-risked on the investment side, what's left is your demographic, and in particular your mortality risk and longevity risk. There's a clear market product out there to deal with that alone, and that's a longevity swap."

However, sometimes when schemes have de-risked their investment strategies, they don't get the return they need to pay the premium on a longevity swap. That was the ICI Pension Scheme's position, so it would have had to pay the premium in cash.

That type of deal doesn't always work from an insurance perspective because it uses investment and longevity risks to offset each other. ICI realised it would be more cost effective, and better on a risk-and-reward basis, to complete their buy-ins rather than trying to remove each risk individually.

MONITORING RISKS

Once trustees have identified the risks they want to remove they will be in a position to monitor them and compare their progress against their objectives, but they will need some help to find this information. Two thirds of schemes assessed and monitored risks in their scheme using regular reports from the scheme actuary and their investment consultant – this was by far the most popular source.

We also wanted to know how often their schemes monitored their funding levels, on both a technical provisions and a buyout basis.

Almost all (94%) schemes monitored their funding level on a technical provisions basis at least quarterly, and 81% did the same on a buyout basis.

Generally, schemes monitored how close their funding level was to buyout less frequently than they checked their technical provisions – a fifth of schemes monitored on a buyout basis less regularly than annually, whereas just 6% monitored their technical provisions so infrequently, and 14% checked their technical provisions daily.

BUYOUT ESTIMATES

The scheme actuary continues to be influential when it comes to buyout estimates. The vast majority (80%) of schemes get an estimate of their funding levels from their scheme actuary, and 81% of those were either confident or very confident the estimates provided were reflective of actual market pricing.

The second most popular source of regular buyout premium estimates was an online analytics tool, which 17% of survey respondents used.

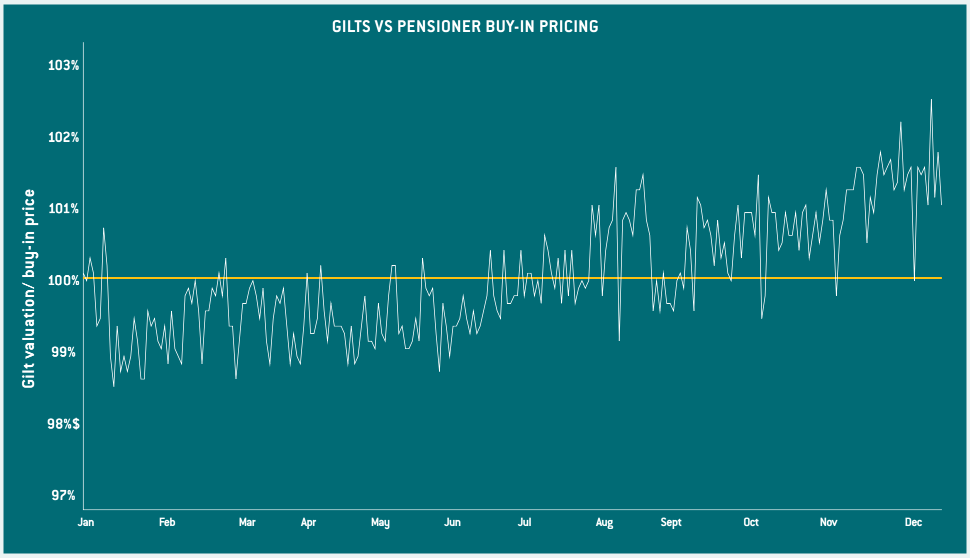
REINSURANCE

Insurers also have to think about how they handle their own risks – most will transfer some longevity risk out to a reinsurer, who won't normally take on the investment risk.

"The reinsurance market as a global market has the capacity to at least take on the current volume and predicted 2015 volume of business," says Jane Childs, a partner at law firm Mayer Brown.

RECENT PRICING OF BUY-IN POLICIES

When a pension scheme is considering a buy-in strategy, the cost of the policy is an important factor. Legal & General explains how pricing works, and the factors which influence the premium the scheme will pay



The price of a buy-in policy is primarily driven by the risk-adjusted investment yield on the assets held by insurers to support the liabilities insured. Essentially, the higher the yield, the lower the price will be. In addition, the buy-in price will be affected by the cost and availability of hedging instruments for pension indexation. Finally, insurers include an allowance for the expenses of administering the policy and a return on the capital they need to hold against the various risks underlying the policy.

What we focus on here is the market factors impacting pricing which are illustrated in the chart above. The chart shows how the cost of a pensioner buy-in policy would have varied over 2014 as a result of changing market conditions relative to a gilts based self-sufficiency metric.

There are two obvious conclusions to be drawn from this analysis. Firstly, that bulk annuity pricing improved over the course of 2014 relative to gilts – this is largely driven by a steady increase in credit spreads over the second half of the year. Therefore schemes should expect greater affordability as we begin 2015, relative to gilts.

Secondly, even for a scheme which is well hedged against interest rates and inflation there is still volatility in its buyout funding level. Whilst in percentage terms this may not appear to be material, for large pension schemes this can represent tens of millions of pounds. As such, schemes who are ready to capture market opportunities could de-risk more efficiently.

As well as general market movements in credit spreads and the costs of interest rate and inflation hedging, the availability of other asset classes will also influence pricing. Insurers, like Legal & General, also invest in more illiquid, longer-term and higher yielding investments such as infrastructure. These assets can lead to improvements in pricing which may result in short term opportunities for pension schemes to access insurance at more affordable levels. Pension schemes with the ability to move quickly to implementation have benefitted from achieving significantly better pricing than would generally be available as a result of these insurer investments.

As well as the cost of interest rate and inflation hedging, the availability of other asset classes will influence pricing

CASE STUDY

MNOPF

WHEN PART OF A MARINE FUND DRIFTED INTO DANGEROUS WATERS, AN INSURANCE-BASED DE-RISKING STRATEGY PROVED THE PERFECT OPTION

During the lifetime of the Merchant Navy Officers Pensions Fund (MNOPF), around 3,500 employers participated in the 'old' scheme. This was set up in 1937 and closed to future accrual in 1978, when the 'new' section opened. When trustees investigated whether they could collect contributions from employers in the event of a deficit in the old section, they only managed to trace 300.

Andrew Waring, chief executive of MNOPF, said: "Of those 300, we found that fewer than 50 had any assets to speak of." Matters were not helped by a weak employer covenant.

After the financial crisis in 2008, the scheme's funding level plummeted to 81%. The 2009 valuation revealed liabilities of £1.3bn and a deficit of around £150m. By the end of 2009 the scheme, helped by recovering financial markets and robust investment management, recovered its deficit and was in a position to insure its liabilities.

This was part of a ten year plan that targeted a funding level of 105% (on a gilts basis). With an underlying investment strategy, broadly made up of passive equities, bonds, alternatives and property, the plan aimed to minimise volatility.

The old scheme underwent three buy-in transactions, the first two in 2010 with Lucida, which has since been acquired by Legal & General, and the third one with Rothesay Life in 2012. Having now insured a liability of £1.3bn, trustees started to lay the ground for a full buyout of liabilities, which took place in July 2014.

This final transaction secured the long term benefits of all 40,000 members and meant the old section can be wound up.

Cleaning scheme data was integral to its success. The task was so extensive that 18 people worked on it. "It was a multi-million pound project," said Waring.

Trustees also had to make sure that members understood the buyout process. This was done in a number of ways, including roadshows and online communications. A single point of contact was also established for scheme members, whose pension payments will now originate from a combination of Legal & General, Rothesay Life, or the new section of the MNOPF scheme.

Now trustees are faced with managing the risks associated with the new section of the scheme. According to its 2012 actuarial valuation it has more than 27,000 members; assets of £2.4bn; past service liabilities of £2.77bn; and a gross deficit of £363m.

Trustees are also looking at hedging the scheme's longevity risk. "We are not expecting to do a buy-in for several years, but our aim is to fully de-risk," said Waring.

According to Waring, the new scheme has a stronger employer covenant and its 10 year recovery plan will collect hundreds of millions of pounds in extra contributions by 2022.

SCHEME NUMBERS

1937
The year the old scheme originally launched

£1.3bn
The amount of liability the trustees insured in three buy-in transacations

£2.4bn
The value of assets in the MNOPF's new scheme

05

INVESTMENT STRATEGY

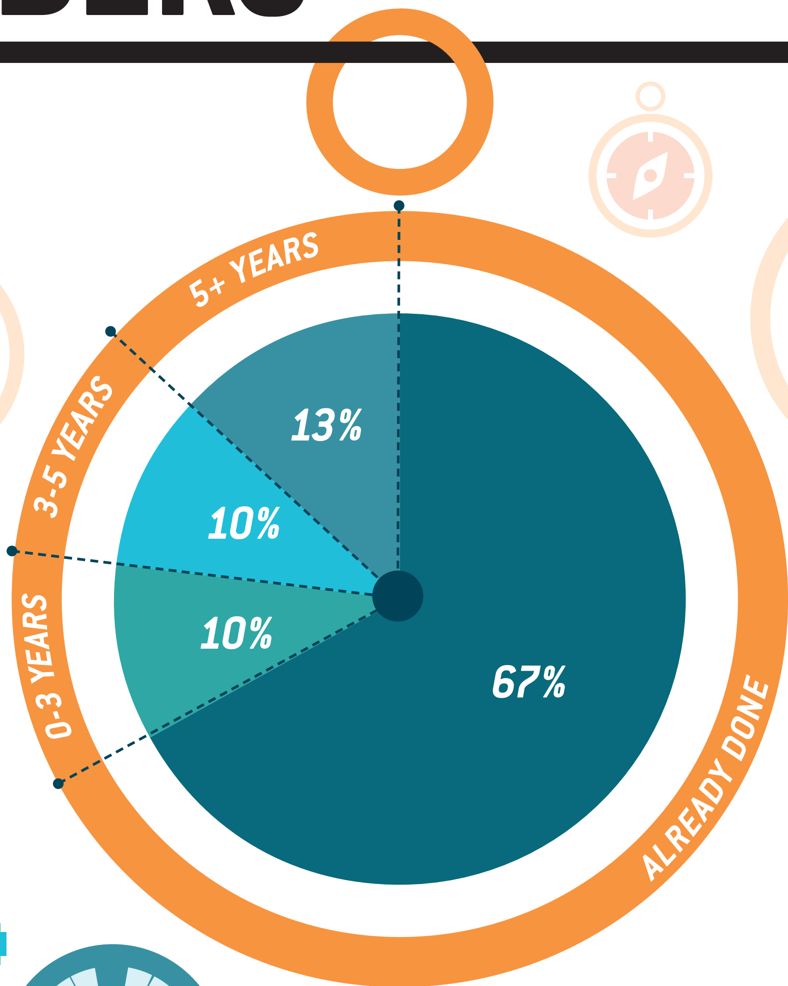
PIONEERING LDI
How the largest schemes are using liability driven investment

GROWING ASSETS
Which asset class will prove the most popular?

EXTRA PREMIUM
Why schemes are looking to illiquid assets for extra returns

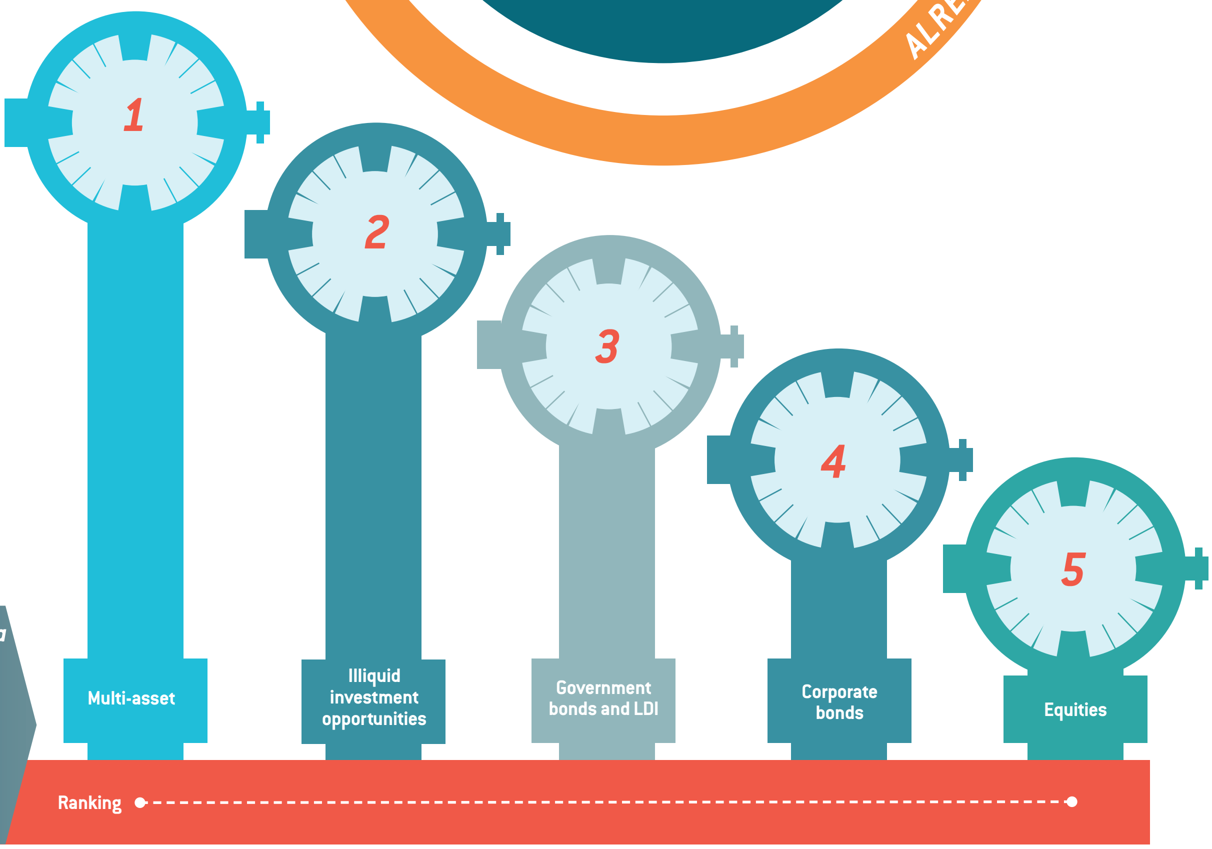
IN NUMBERS

Time horizon for implementing liability-driven investment



"Multi-asset comes in so many different flavours, and you have to understand the flavour you're buying and why you want the flavour"
Barbara Saunders, director of asset solutions, P-Solve

Main growth area of investment strategy in the next 10 years



PENSION FUND PIONEERS

Where large schemes go, smaller schemes will usually follow. Louise Farrand looks at some of the innovative investment strategies the £1bn plus pension funds are using to meet their liabilities and objectives

Large schemes are truly investment pioneers, blazing a trail into esoteric new asset classes and strategies. They're often the first movers into experimental new growth strategies, so it's no surprise that our survey shows similar foresight and imagination when it comes to de-risking those same assets.

A high proportion of large defined benefit schemes (67%) have already implemented liability driven investment (LDI). All schemes must put a price on their liabilities, which are inevitably affected by external factors like interest rate and inflation risk. Therefore, it makes sense to make managing those liabilities a priority, and to tackle them head-on when determining investment priorities.

But what exactly is LDI? For the uninitiated, it effectively means holding investments which track the moving liabilities of a pension scheme over the lifetime of those liabilities. Large schemes were early adopters of the strategy, which started life as a relatively sophisticated option, mainly available to large schemes – again rendering it unsurprising that so many schemes we spoke to had already introduced it.

LDI won't be right for every large pension fund. There are some well-funded schemes with long investment timeframes and/or a robust, supportive employer. However, there aren't many schemes which can absorb such high levels of risk in the long term, making LDI a strategy that is suited to the vast majority.

For the 33% of schemes which haven't yet adopted LDI, there are a number of factors to consider. "Before you implement it, you need to be sure what your long-term objectives are," says Rod Goodyer, a partner in consultancy Barnett Waddingham's investment consulting team.

"Some schemes will be targeting a buyout, but for the very largest schemes that may not be so practical, both in terms of the capacity of the market and also the cost potentially to the employer if they are going to have to top up to reach a buyout.

"Some schemes may be looking more for a self-sufficiency target," says Goodyer, who makes the point that this different objective will affect the way a scheme invests. If schemes are targeting buyout, they will need to leave some money invested in growth assets to propel them nearer to that target. However, if schemes are targeting self-sufficiency then investing in more illiquid, long-term asset classes with steady returns – infrastructure, for instance – may be a better way forward.

The timing of moving assets into LDI is also important. That said, the prevailing economic climate should not necessarily stop a scheme from making the transition, says Barbara Saunders, director of asset solutions at investment consultancy P-Solve.

"[Bond] yields have fallen so much that schemes have felt the pain, so to hedge at this level feels a bit uncomfortable. What we would be advising schemes to do in situations like that is to hedge gradually, not necessarily waiting for a particular interest rate level or time, but maybe gradually over the next six months or so, so that you know you didn't hit the bottom and do it at the wrong time," she says.

Illiquid investment opportunities like infrastructure and multi-asset were two other areas big schemes highlighted as growth areas. A quarter of the large schemes we spoke to said they were considering infrastructure, social housing, and other illiquid investment opportunities.

Large schemes often have more flexibility to invest in such asset classes. They commonly have longer investment timeframes and with their greater purchasing power, are able to achieve economies of scale which small schemes would struggle to attain. »

» As Goodyer puts it: "If I'm a £10bn scheme, it's easier for me to put 2-3% of assets into something less vanilla and I'll get a bit of pickup from it and it's not a disproportionate cost, but if I'm a £100m scheme, then I'm going to hit minimum investment amounts and the advisory costs going into them, understanding them and monitoring them may be disproportionate. Large schemes can also go into things directly, which takes out some of the problems that smaller schemes have."

Saunders is cautious on infrastructure. "We think it looks very good on paper but actually in practice the access is difficult and/or quite illiquid, so it doesn't give you the opportunity to change your mind." However, insurers are investing regularly in this type of asset and so there may be scope to transfer these to insurers in future.

Pension schemes stepping in to replace banks as lenders is another illiquid investment opportunity which Goodyer reports is increasingly of interest to large pension schemes. "Because we've seen this big boom in liquid assets in recent years that's lifted everything, the schemes are starting to look a little bit harder at less liquid, private things which aren't so easy to access. Again it's an area where large schemes may have an advantage; these lending funds where banks have operated in the past but now maybe large pension funds can do the same."

"The whole idea is buying things that look cheap and selling things that look expensive"

Multi-asset is another growth area for large schemes, with a quarter of large schemes citing them as of interest.

How exactly do you define multi-asset, which the market also sometimes refers to as diversified growth funds? Saunders says: "We don't think of multi-asset as an asset class. We think that some of the things some of these multi-asset funds are trying to do is active asset allocation, the idea of buying a bit more equity when they look good value, buying a bit more Japan now that Japan's easing strongly, reducing allocation to Europe because it looks like they are going into a deflationary scenario, maybe reducing your allocation to the US because it's done so well over the last few years. The whole idea is buying things that look cheap or look as though they have a very positive outlook and selling things that look expensive."

Seeking returns from a more diversified pool of assets makes intuitive sense, says Goodyer. However, he cautions that multi-asset funds are a relatively new phenomenon and have not faced any significant tests yet, operating in the bull market of recent years. Instead, schemes should be asking whether their multi-asset fund has picked up sufficient upside in recent years to cushion any future downside, he says.

It's also important to pick the right multi-asset fund (or funds) for your scheme. There are multi-asset funds and multi-asset funds, Saunders believes. "In my view, there are too many diversified growth funds that are just sitting there in a multi-asset allocation, essentially doing asset allocation for you in a one-stop shop but ultimately you could do that for yourself and for much cheaper."

She continues: "Multi-asset comes in so many different flavours, and you have to understand the flavour you're buying and why you want the flavour – how it fits with the rest of your portfolio."

Schemes should be careful not to replicate strategies contained elsewhere in their portfolio when choosing a multi-asset fund. "If you've already got a couple of hedge fund strategies and then you put in a multi-asset strategy which has a hedge fund strategy within it, it's maybe not what you needed. What you perhaps needed was something a bit more vanilla, which is just looking at asset allocation and varying it over time," says Saunders.

In large schemes where so many different and complex investment strategies co-exist, it's important to propel investments in an overall strategic direction as well as maintaining a forensic understanding of what's happening under the bonnet. It's a challenging task – but who ever said running a pension scheme was easy?

WHAT'S NEXT IN LDI?

Aaron Meder, head of investment at Legal & General Investment Management, discusses the future of liability driven investment as pension schemes reach their endgame

Aaron Meder
head of investment,
Legal & General Investment Management

When it considers the primary objective to ensure that members' pensions are paid in full and on time, every defined benefit pension scheme eventually needs to think about its endgame.

The endgame is likely to take one of two forms, as specified by over 90% of respondents:

• Buyout: Pay an insurance company to take on scheme liabilities and pay benefits (11%)

• Self-sufficiency: Manage the scheme's assets to produce the required cashflows to pay benefits, which may include investment in longevity insurance or an insurance buy-in (81%)

We expect the preference for self-sufficiency investment strategies to continue for the foreseeable future, but as schemes mature and funding levels improve, the focus on buyouts is likely to increase. Ultimately, for all schemes, there will be a point where it is cheaper to buyout the scheme than to continue to manage it on a self-sufficiency basis.

For all schemes there will be a point where it is cheaper to buy out the scheme than to continue to manage it on a self-sufficiency basis

CORPORATE BONDS ARE GOING TO BE MORE IMPORTANT THAN YOU THINK

Whether the endgame is buyout or self-sufficiency, we believe that pension schemes will seek to achieve their endgame by investing in a low risk manner similar to how insurers invest to back pension annuities. As with insurers, at the heart of this will be a significant allocation to cash-flow-oriented investments, in particular corporate bonds.

For schemes targeting buyout, the corporate bond allocation aims to deliver returns in excess of the buyout liabilities, match changes in buyout pricing and be cost efficient to liquidate or transfer to the insurance company at buyout. We estimate that an 'average' scheme would need to invest approximately two thirds of its assets in corporate bonds to match the corporate bond sensitivity of pensioner buyout prices. In order to track buyout pricing most efficiently, the size and composition of the corporate bond component should be dynamically managed based on both market and insurance specific factors.

For schemes targeting self-sufficiency, the focus will be on bond investments which deliver cashflows at the right times to pay pensions as they fall due. Some clients will seek further risk reduction through longevity insurance or buy-in transactions. Currently, the average self-sufficiency target amongst our clients of gilts plus 0.5% suggests that they expect to have more than half of their assets invested in corporate bonds once they reach full funding (assuming that corporate bonds generate a yield of approximately 1% over gilts).

As a consequence, we believe that LDI strategies will evolve to reflect a more holistic investment strategy where corporate bonds, government bonds, swaps and any other 'matching' assets are managed together against a distinct liability benchmark, to generate a return in excess of this benchmark, minimise costs, and pay pensions. »

» We are seeing increased demand from our clients to manage their 'matching' assets to deliver such long term endgame objectives. Increasingly, our clients are expanding their LDI mandates to include corporate bond portfolios with relatively low turnover, designed to pay pensions as they fall due. In addition, we are increasingly focused on identifying market opportunities to generate excess returns by actively managing the allocation between corporate bonds, government bonds and swap-based LDI investments within a self-sufficiency strategy.

ATTENTION WILL TURN TO ILLIQUID ASSETS AS A SOURCE OF LONG TERM RETURNS

Increasing interest in illiquid investments (with 28% of respondents citing illiquid investments as the main growth area for investment over the next ten years) is no surprise given their potential to generate excess returns and help pay pensions. They are very long term, can be bond-like in nature and potentially provide an 'illiquidity' premium above gilts. However, illiquid assets are, by their nature, difficult to value or sell. This can present problems in terms of assessing a scheme's funding level or if the assets need to be realised to pay pensions. In addition, schemes will need to factor in the ability (or not) to transfer such illiquid assets to an insurance provider at buyout.

Liability benchmarks will include a corporate bond based discount rate and become more precise

We expect liability benchmarks to evolve from a simple 'gilts plus x%' basis, to a basis where the liabilities are discounted based on the expected return of the assets (and therefore corporate bond-based discount rates). This will mean valuing the funding position in a similar way to the way that insurance companies consider their assets and liabilities – i.e. are the current assets (after expected defaults and expenses) expected to be sufficient to pay benefits?

In addition, the closer to a fully funded position and full matched position that a scheme gets, the more important it is that the estimated cashflows are correct. Consequently, we expect to see closer collaboration and information sharing between actuaries, administrators and investment managers to define cashflow requirements and the liability benchmark so that the assets can be managed to reflect changes in the membership profile, liability assumptions and market conditions.

In this new world, the definition of success will no longer be "I'm 100% funded, but with an acceptable level of risk"

CONCLUSIONS

Over the next ten years LDI will move away from its historic focus on reducing funding level volatility by matching asset and liability sensitivities to interest rates and inflation. Instead the focus will move to matching cashflows through holistic management of a range of bond-like assets (including corporate bonds and illiquids) to minimise risk, generate excess returns and ultimately, pay pensions in full.

In this new world, the definition of success will no longer be "I'm 100% funded, but with an acceptable level of risk", but will move to a more practical assessment: "I'm solvent, I expect that interest and principal receipts from my assets to be enough to pay benefits as they fall due with an acceptable level of probability".

Legal & General Investment Management was one of the first managers to offer Liability Driven Investment (LDI) strategies and in 2014 were independently accredited as being the largest LDI manager in the UK, across both pooled and segregated mandates, for the second year running *(Source: KPMG LDI survey)*.

2015 ECONOMIC OUTLOOK

As pension schemes consider their de-risking options they will want to know which direction the economy is heading, and when would be the best time to buy a policy. Legal & General Investment Management gives its view on how 2015 will pan out economically, and what that means for trustees looking to take the risk out of their schemes

In 2014, global growth failed to deliver on optimistic expectations but growth should gradually strengthen in 2015 as monetary policy deviates between the US and UK versus the euro area and Japan. Certainly the market believes there is a low chance of further quantitative easing in the UK (it's a little different in Europe), but the timing of a Base Rate increase, if it comes at all this year, is far from clear.

At one point in the last year, around the 'Carney moment' – where the Governor of the Bank of England warned that rates could rise "sooner than people think" – consensus forecasts for that first rate increase were brought forward into 2014. But subsequent data – notably a stalling housing market, very poor euro zone growth, falling commodity prices, lower inflation and weak wage growth combined to push the expected date back into 2015 or even 2016.

Brent oil prices have fallen dramatically since 2014's highs in June and OPEC aren't budging on production in what is increasingly emerging as a 'Saudi versus Shale' movement. Lower overall commodity prices have anchored down inflation, which was already very low. Indeed, inflation has already fallen below 1%, and this deviation has warranted the first letter ever from the Bank of England to the Chancellor with an explanation for an undershoot.

With inflation so near to zero – even if this is due to temporary effects – we think that the Bank will have to err on the side of caution in case inflation expectations fall further, leading to second-round effects through lower wages and price setting. The BoE hasn't faced this situation before, and the Monetary Policy Committee has recently had a number of split votes, making it difficult to predict its actions. As a result, we believe that, at present, the most accurate statement we can make on interest rates is that we think the bank will wait for longer than previously thought.

However, this rate rise uncertainty creates certainty elsewhere, specifically on economic growth. Wage growth is showing initial and tentative positive signs. Employment growth remains robust and survey data suggests that this will continue, leading to further wage growth. At the same time, although oil prices do not affect the UK consumer as much as these do in the US, any decrease effectively feeds through to consumer pockets with similar effects to a tax cut.

The fall in inflation makes forecasting interest rates much more uncertain. But more jobs, the potential for higher wages and falling inflation form a terrific backdrop for the UK consumer. This in turn gives us much greater confidence in our expectation that UK growth will be above trend over 2015.

So what does this mean for clients looking to de-risk?

Whilst long term bond yields are low by historical standards, this may well persist in the current environment. There is a chance, if UK economic data and wage growth do strengthen, that rate hikes may occur sooner than the market has currently priced in, which could lead to de-risking opportunities for those schemes that are well-prepared and are able to react quickly. In addition, reduced inflation expectations may offer an opportunity to protect more cheaply against future inflation risks. Consequently, we believe that a sensible strategy is to gradually build up interest rate and inflation hedges towards a better-hedged position, while getting the right "plumbing" in place to capture changing market opportunities. Being poised to lock in profits on growth assets, or to take advantage of changes in bond or swap yields, can help schemes to enjoy a smoother ride, with fewer nasty surprises, on their de-risking journey.