PENSION BUY-OUTS AND LONGEVITY HEDGING 2014

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Examining the developments behind the increasing popularity of bulk annuity and longevity hedging transactions, and what the future of these popular de-risking strategies may hold.

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1.1 INTERVIEW

Considering the obstacles restricting bulk annuity transactions from reaching completion

Interviewer

Chido Tagarira
Senior Publisher, Clear Path Analysis

Interviewee

Ian Eggleden
Scheme Manager, PS Independent Trustees

Chido Tagarira: What factors do schemes need to consider before going down the buy-out, buy-in, or longevity swap route?

Ian Eggleden: First, it is important to understand why the trustees are doing this. It could perhaps be to reduce risk in the pension scheme, but whatever the reason, you need to understand what you are trying to achieve and why.

Investments need to be in order so that the scheme can receive the best price as most insurers will want to have assets that are a mixture of bonds and gilts or similar. This means that if you are fully invested in equities, there will probably be various swings in the pricing. In other words, if the price is £10 million but equities are going up and down, at one stage you may have more than £10 million whilst at another time you may have less. It is usually better to be invested more strategically in bonds and gilts, then the pricing will most likely move in a similar direction as the value of assets.

Another factor to consider is whether the scheme has the money available as some insurance companies require cash rather than the assets that you hold so you may have to sell investments to do the transaction. These schemes may also need a top-up from the company to complete the transaction.

It is also important to consider whether your data is in a state where the insurers can pick it up and know that they have a very clear idea of exactly what risk they are taking on. Sadly, some schemes don't have their data in good order and this is one of the reasons why they may face problems completing as the insurers may withdraw their quote, or increase the price for the additional risk, if they don't feel comfortable with the data.

Chido: What is the trustee's role in this?

Ian: The trustee's role is critical as they have to lead the process. There have been occasions where a company has been very keen on a particular buy-out and intent on moving very quickly which meant that some issues were missed and later led to problems. So the trustees need to be well-advised and in control of the process. They also have to recognise that they have a responsibility to look after the members and that includes issues like data protection. So when they send data to external advisors or insurers, they need to ensure that this data is properly protected to avoid giving people data for the wrong reasons or indeed giving the data to the wrong people.

Chido: What are some of the other reasons behind some bulk annuity transactions not reaching completion aside from the data issues you just mentioned?

Ian: Occasionally there are a lot of deferred pensioners (people who haven't retired yet) and very few pensioners. Some of the smaller insured schemes buy an annuity from the insurance company when members retire because the scheme has always been run by the insurance company. So given that these pensions have already been bought out, if you are then asking an insurer to take on liabilities solely for people who haven't yet retired, this isn't as attractive. With pensioners you have a more predictable mortality risk that insurers can look at. Whereas deferred pensioners are younger so it is more difficult for insurers to price the risk.

Trustees can sometimes work in conjunction with the company in order to get medical information about members of the pension scheme before they try to buy-in or buy-out. Knowing more than just the basic details about someone, for example whether they have had illnesses (which could mean that their life expectancy is not as good as someone who is healthier), can enable you to get a better price from the insurer. Clearly there is another data protection issue here and you cannot force anyone to give you information about their medical history. However, there have been many occasions where companies or trustees have successfully asked members to give them medical information. Incentives such as offering Marks and Spencer vouchers, or the like, can work. Trustees have then collected this data, sent it off to the insurer, and have managed to obtain a much better price because of this added information.

Chido: With these medically underwritten annuities that you just referred to, the scheme could potentially be opening themselves

up to challenges if they find that they have healthier than expected members.

Ian: If everyone's medical comes back claiming that they are in great health that could put the price up, but normally you find that there is a mix. If there is more of a swing towards the less healthy, particularly if they have been in less healthy jobs, then you can actually get something out of that. It is down to the insurer to price the contract based on the medical information provided to them. If they are comfortable that the evidence for any individual is strong enough to offer a better priced annuity then they have committed to paying that member's pension for life regardless of how long they live.

However, there are also many legal reasons why deals don't complete. For example, if you are working with an insurer and you find that perhaps the contracts are unacceptable, or the security of that insurance company isn't as strong as you would like it to be, then people might get nervous.

Chido: **How is the acquisition of certain providers by larger conglomerates influencing investors' accessibility to these de-risking strategies?**

Ian: Overall, one would hope that acquisitions are going to increase the size of one's chosen insurance company and although it does give some financial strength, size isn't everything. It is a question of how the assets and liabilities stack up with the reserves that they hold, and if one's insurance company is struggling to get enough capital to run the business, then being acquired by a company that has the reserves to do that can help to win new business and put them in a winning situation.

My concern is that there isn't enough capacity because if every pension scheme wanted to go through a buy-in or buy-out, it would probably be physically impossible as there isn't enough capacity within the market. So it would be good to see more companies enter the market rather than just having companies being acquired by bigger firms.

Chido: **At this stage it doesn't seem as though there have been enough deals that have reached completion where we can say for certain that there is a supply and demand issue, but I suppose there will come a time in the not too distant future where this could be the case?**

Ian: Yes and the other question that no one knows the answer to is which of the insurers from the buy-out market is going to fail first. Hopefully there won't be any that fails but if it can happen, it will. There are pieces of legislation that would help the annuitants but it is not a good situation to fall into.

Chido: **Do you think there is a shift taking place in the bulk annuity market place where insurers will be calling the shots and schemes looking to transact may face rejection?**

Ian: That has taken place, certainly for some of the smaller pension schemes who have not been able to get the sort of terms that they would like because it is not attractive business for various reasons. It is only the medium to larger schemes that are finding a choice in the market as many insurers aren't interested in the smaller schemes. This is not a good situation from a competitive standpoint.

But when there is a real reason for doing these transactions, the trustees and the company that sponsors the scheme will often accept the terms that are offered because they are the only terms available. It can still be a good deal for them because they are achieving their objective of reducing the risk in the pension scheme, although at a slightly higher price than they might have had if there was more competition.

Chido: **What changes in the market place do you expect we will see over the next 12-18 months?**

Ian: If pricing is expensive for the buy-in or buy-out, then there is always the alternative of trying to get the longevity risk off the table. If you can do some transactions in this space then that might achieve half of the objective, if not all, and there are lots of financial reasons why sometimes a buy-in isn't necessarily any more attractive than simply doing a longevity swap. With a longevity swap, you have still got your assets invested to pay pensions from the scheme and if they do well then you will be better off than having sold off your liabilities to the insurance company.

Chido: **There are also these new index linked longevity swaps as well which are becoming more popular.**

Ian: Indeed and these are more for the larger schemes than the smaller ones because the transactions are so costly in terms of time and complexity to put together. It is going to be buy-ins or buy-outs for the smaller schemes and longevity swaps will only really be for the larger schemes until the market evolves further.

Chido: **Thank you for taking the time to share your insights on this.**

"insurers may withdraw their quote or increase the price for the additional risk if they don't feel comfortable with the data."

1.2 CASE STUDY

The British Arab Commercial Bank buy-in transaction

Andy Morley
Head of Enhanced Annuity Sales, Partnership

Company Overview:

British Arab Commercial Bank (BACB) was established in London on June 1972 as a wholesale bank and a leading provider of trade and project finance for Arab markets. Over the last 41 years, the institution has helped exporters to capitalise on opportunities in markets of growing significance, either for existing traders or those contemplating Arab markets for the first time.

As a UK based-company, BACB offers qualifying staff members access to a range of benefits which included - at one time - a defined benefit pension scheme. While it is fully committed to offering employees a competitive employee benefits package, the organisation is also aware of the impact that these resulting liabilities can have on their company's balance sheet.

Therefore, BACB has previously chosen to de-risk tranches of pension liabilities from its £60m scheme and has worked closely with the trustees – including the Independent Trustee from BESTrustees, one of the UK's leading independent trustee companies – on these transactions to make them a success. In addition to achieving the stated objectives of each deal, the fact that the company has undertaken more than one means that they are now somewhat 'battle hardened' and fully understand what is required.

The Challenge:

In 2013, the company reviewed its pension scheme and agreed with the trustees that it would be beneficial to de-risk a further tranche of £12 million worth of liabilities. Following a discussion with JLT Employee Benefits, it was decided that with the company and the trustees existing experience in the de-risking arena, they would be the ideal candidate to undertake the industry's first whole of market underwritten buy-in transaction.

As a leading employee benefits provider, JLT Employee Benefits has worked hard to address the barriers to clients undertaking medically underwritten buy-in deals as they can frequently offer better, more tailored value to a scheme and its members.

One of the biggest hurdles to overcome was member engagement as under the current system each insurer who quoted would require some contact with the scheme members for no monetary benefit for themselves. Therefore, the standard approach was for a company to sit down with its trustees and advisers to choose the insurer they felt would be the most appropriate for their specific needs and then ask them to provide a quote.

One of the risks of this approach is that if the company decides not to proceed with a specific insurer as – for example – the quote is judged to be too costly, they would have to go through the entire process again if they wanted to use one of their competitors. Some companies may then decline to quote as they are concerned that the previous medical questionnaire may have highlighted issues which mean that their quotes will also be viewed as uncompetitive.

> Graham Wardle, BESTrustees, Chairman of the Trustees, said:
> "With a response rate representing 95% of the pension liabilities, we were able to give the insurers detailed information to accurately price this whole of market buy-in exercise. With JLT Employee Benefits advising us, we were able to achieve a competitive price by selecting Partnership Assurance and we are pleased with how streamlined the process was. The continual de-risking of our pension scheme is an important goal and ensures long-term security for our members."

The Solution:

Therefore, JLT Employee Benefits developed a new process whereby a third party – MorganAsh – an experienced provider of administrative services and medical assessments – engaged with scheme members to collate medical information. This was done via the common quotation request form with the results provided to all insurers who had been approached and indicated that they were willing to quote (three in the case of the BACB scheme).

While de-risking allows the scheme to reduce its liabilities, it does not offer members additional benefits apart from the reassurance that their pension is now managed by an insurer who has significant experience in the post-retirement market. Therefore, it can be a challenge to encourage them to provide medical details to aid the de-risking process.

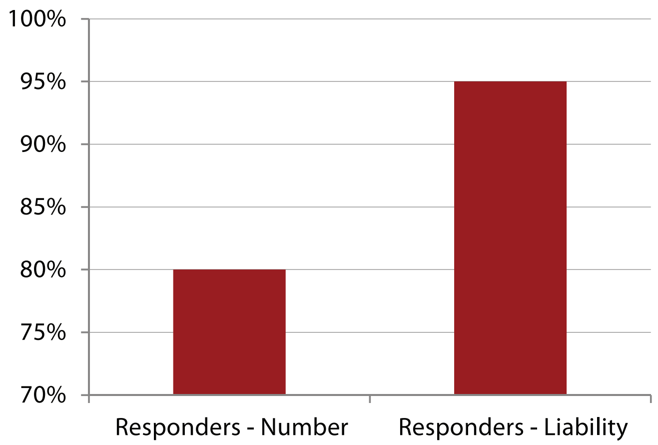
> David Barratt, Buyout Consultant, JLT Employee Benefits, said:
> "This new process for completing underwritten buy-in transactions is an important step for Schemes looking to de-risk in the most cost-effective way. We are continually looking to improve efficiencies for our clients and are delighted to have brought this new process to the market, which we feel will revolutionise the medically underwritten buy-in market."

Therefore, the questionnaire was carefully designed to combat this by being short and simple while at the same time providing the depth of detail needed by insurers. Having learnt from experience with other de-risking exercises, the trustees actively encouraged members to engage in the process and highlighted the potential benefits via a letter included in the contact packs.

Of the 45 forms issued to members of the BACB scheme, 38 were returned within 4 weeks - an 84% response rate. Of these, GP reports were sought for 31 people (23 members and 8 spouses) as either their responses on the returned form warranted further investigation or they were 'large liability' scheme members.

Interestingly, those people who had larger pensions were more likely to respond so the information obtained actually covered 95% of the scheme's liabilities.

Response rates



Following the collation of the data, it was then provided to the insurers to accurately quote for this de-risking exercise. While the data in this case was identical, this need not always be the case and in the future it is envisaged that insurers who quote may be allowed to request certain data sets as part of the process.

Of the three insurers who quoted, Partnership Assurance – a FTSE 250 specialist insurer – provided the successful bid. The company boasts proprietary underwriting manuals and mortality data which they use to offer enhanced retirement products for those with health or lifestyle factors. This stood them in good stead when they entered the de-risking market in 2012 and has helped them to price a variety of deals competitively.

Indeed, having gained a certain amount of expertise in the market due to repeat transactions, BACB was pleasantly surprised to find that the quotes they received from the providers as part of this whole of market underwritten buy-in transaction were below what they had expected.

From first speaking to JLT Employee Benefits about the need for a de-risking exercise to completion, the entire process took 12 weeks and provided BACB with a cost-effective solution to pension liability mitigation. This clearly shows that while the whole of market medically underwritten buy-in approach may seem more complex than the standard bulk annuity purchase, it does not need to slow the process down and can provide better outcomes for all concerned.

> Andy Morley, Head of Enhanced Bulk Annuity Sales, Partnership Assurance, said:
> "We were happy to support JLT Employee Benefits in developing this new market process. A common approach to the collection of health and lifestyle information from members will ensure that Schemes wishing to de-risk through an underwritten exercise will now have a choice of insurers and can be confident of attaining a competitive price. Trustees of the British Arab Commercial Bank Pension Scheme have made an important step in de-risking their Scheme and the transaction represents a key landmark in the development of the underwritten bulk annuity market."

De-risking options for the SMEs

Julie Stothard
Director of Actuarial, Investment and DB Consulting at Capita Employee Benefits

"Start by doing what's necessary; then do what's possible; and suddenly you are doing the impossible". St Francis of Assisi

For many trustees faced with seemingly never-ending deficits, the ideas of de-risking, self-sufficiency and buy-out must indeed seem a mission impossible. This is often particularly true for those who are trustees of smaller schemes – perhaps schemes with 'only' a few hundred million pounds of assets.

This is a market that has been traditionally poorly served by some consultancy firms and insurers alike, many of whom have focused on the very largest schemes. However, things are changing and we have worked together with insurers for a number of such 'smaller' clients to achieve significant de-risking successes through exercises such as longevity swaps, innovative buy-ins and pension increase exchanges.

However to carry out targeted de-risking exercises (the possible) in order to reach self-sufficiency and buy-in or buy-out (the impossible), it is important for trustees to do the 'necessary' to get to this position.

The necessary, in our view, revolves around trustees establishing three key certainties:

- Are we paying a fair price for our core services?
- Is our data accurate and complete?
- Do we understand the relationship between our assets and our liabilities?

We would describe the core scheme services as constituting the actuarial work on valuations and funding, regular consultancy on legislation, regulatory developments and governance alongside an on-going investment framework.

We still find many smaller schemes are using up a large portion of their time and monetary budget on these core services; often, but not exclusively, where elements of a core service are being provided by a number of firms or indeed where the provision of each service is carried out by a separate team within a single organisation.

Trustees should feel reassured that there are alternatives in the market and it is a market which is competitive with fixed fees available for some services and pressure on hourly rates and clarity of scope for others. By ensuring that they are getting the best value for these core services, trustees can, in effect, increase their available budget without recourse to their sponsor and initiate other necessary projects to move de-risking opportunities into the realm of the possible.

Accurate and up-to-date data is critical for the proper operation of a pension scheme and trustees have the ultimate legal responsibility for the quality and accuracy of member records. The Pensions Regulator has been very clear in its views and trustees have been obliged to comply with its guidance since the end of 2012.

High quality data is also a prerequisite for the completion of many de-risking projects and can have a material effect on the cost of some exercises. By way of example, the insurer Aegon recently estimated that missing spouse data can add as much as 15% to the cost of a longevity swap arrangement. Even for 'smaller' schemes, this price differentiation can run into millions of pounds and have a material impact on the feasibility of an exercise.

The final element of 'necessary' is accessing tools which provide insight into the asset and liability dynamics of a scheme. Too often trustees are handicapped by a lack of up to date information: knowing that an opportunity to remove risk existed several months previously is of little value. Even though many trustees receive information more regularly than the annual funding update, the reality is funding levels fluctuate on a daily basis and trustees can benefit enormously from the monitoring technology that is now available in the market from firms such as Capita. A daily monitoring service allows trustees not only to make informed decisions but also to agree investment triggers to take advantage of market opportunities.

By setting investment triggers, trustees can establish their key indicators for the moments when an opportunity has arisen to lock in gains to the funding level. However, while the trustee board can, and should, debate and agree these identified favourable market conditions (whether affecting assets, liabilities or both), the time required to call an extraordinary meeting or conference call for all the trustees at the moment of opportunity exposes the strategy to the danger of delay. It is therefore often sensible to delegate to a sub-committee responsibility for acting on triggers and reporting outcomes to the trustee board.

Clearly increases in life expectancy have also played a major role in increasing volatility and trustees of smaller schemes should not shy away from also de-risking in this area.

The accurate member data gathered by trustees in the 'necessary' stage now opens up the opportunities to address this longevity risk; for example, the use of longevity swaps allows trustees to fix cash flows in respect of certain elements of the scheme's membership and in so doing, hedge against the impact of increasing assumptions on valuation results. This is an increasingly important option available to trustees to manage their funding level volatility. As longevity swaps are relatively new to many trustees and can carry certain complexities for the uninitiated, there can be an understandable reticence to consider this tool.

However, in much the same way as liability driven investment did previously, the market for longevity swaps is evolving. While longevity swaps were the preserve of the largest schemes, there is an increasing number of providers who are happy to work with forward-thinking consultancies to tailor solutions for smaller schemes. These can be used to cover liabilities beyond the pensioner membership and they do allow later annuitisation should this market subsequently improve.

These are clearly not the only options available to tackle funding levels but are good examples of the 'possible' now available to the trustee of the smaller scheme who has done the 'necessary'.

So now we must consider the 'impossible': the use of strategies to minimise or eliminate risk.

Where the scheme has access to a strong employer covenant, this may simply be reaching self-sufficiency: being funded to meet arising benefits for decades to come until the last member payment is made - without much recourse to the sponsoring company.

However, most schemes are not in this position and safety lies with a strong well-capitalised insurance company. The "endgame" is winding up the pension scheme and buying out all the benefits with such an insurer.

This is an important distinction: if an insurance company is the endgame, then it does not matter what assumptions trustees make about longevity – all that matters is the insurers' assumptions because ultimately that's how the de-risking price will be determined. Therefore trustees need to adjust their assumptions to more closely reflect this economic reality in order to insure benefits.

It is also always worth remembering that a move to an insurer regulated by the UK authorities is usually a better prospect for members than relying on the employer covenant. Even in those cases where the employer covenant may be so strong that insurance is not the answer and trustees in this position can simply pick and choose which risks to pass to the insurer and which risks they can handle themselves - longevity swaps or insurance is a good example of this pick and mix.

In either case, it is only by doing the 'necessary' and 'possible' that allows the trustees the luxury of contemplating which option is the ideal 'impossible' solution as they finally de-risk their scheme.

Innovation in the insurance market and improved market conditions means de-risking is no longer a dream; the process is by no means simple but for those prepared to do the necessary and the possible, the impossible may be closer than trustees think.

"The accurate member data gathered by trustees in the 'necessary' stage now opens up the opportunities to address this longevity risk. . . "

1.4 ARTICLE

Brief summary on the proposed 2014 budget and annuities reform

Andy Morley
Head of Enhanced Annuity Sales,
Partnership

The Chancellor's budget on 20th March has certainly shaken up the pension industry by announcing revolutionary measures on an annuity reform. George Osborne, the Chancellor of the Exchequer outlined significant changes to the operation of Defined Contribution (DC) pension plans.

"We will completely change the tax treatment of defined contribution pensions to bring it into line with the modern world. There will be consequential implications for Defined Benefit (DB) pension schemes upon which we will consult and proceed cautiously."

The government is expected to publish a consultation on changes to Defined Benefit schemes in the next couple of months.

In summary, changes to individual pensions with effect from 27th March;

- Flexible drawdown Minimum Income Requirement limit will be reduced to £12,000 p.a.
- Small pots trivial commutation limit will be increased to pot sizes of £10,000, on up to 3 pots
- 'Trivial commutation' rules that currently allow funds totaling less than £18,000 to be taken as a lump sum will be increased to £30,000
- Maximum withdrawal limit ("Max GAD") on capped drawdown has been increased to 150% of an annuity equivalent

Changes with effect from 2015;

- From next April the requirement to buy an annuity will be relaxed by allowing funds to be withdrawn from pension funds at any time after age 55 with 25% being tax free and the remainder being taxed at marginal tax rates

A period of consultation will now take place on the above measures, which will be open to responses until 11th June 2014. The results will help form legislation which will be presented to Parliament.

How does this affect DB schemes and the bulk annuity market?

The announcement included some reference to DB schemes, including consultation on whether private sector schemes should cease offering Cash Equivalent Transfer Values (CETVs) for early leavers, to follow the proposal that CETVs from public sector schemes should be banned. There is concern that a high proportion of members will transfer from Defined Benefit to Defined Contribution schemes due to the new flexibility available under that regime

Bulk annuities remain a viable way of securing members' benefits for DB schemes looking to de-risk. The budget proposals do not materially change this position and may improve conditions for schemes as more competition may enter this sector of the market.

Partnership is a leading and fast growing writer of enhanced annuities and a specialist provider of financial products that could offer better rates to individuals who suffer from shortened life expectancy. The company is expert in medical underwriting and a leader in the enhanced retirement annuity market.

Partnership has brought this expertise to the bulk annuity market since 2012. The team has over 150 years' worth of experience in the defined benefits market, and has recently completed the largest individually underwritten buy-in to date, as well as the UKs first open tender underwritten buy-in.

For more information visit https://derisking.partnership.co.uk alternatively email derisking@partnership.co.uk for an information pack.

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"'Bulk annuities remain a good option for pension schemes despite the announcement on annuities in last week's Budget' Pension Funds Online 26/03/14"

SECTION 2

MEDICALLY UNDERWRITTEN ANNUITIES AND TRADITIONAL BUY-INS

2.1 ROUNDTABLE

Assessing the suitability of medically underwritten annuities and how their popularity will impact the future of the de-risking market place

Assessing the suitability of medically underwritten annuities and how their popularity will impact the future of the de-risking market place

Moderator

Pádraig Floyd
Freelance Financial Journalist

Panellists

Andrew Cheeseman
Independent Trustee, PAN Group Trustees

Andy Morley
Head of Enhanced Annuity Sales, Partnership

Paul Taylor
Finance Director, The National Society for the Prevention of Cruelty to Children

James Mullins
Partner, Hymans Robertson

Pádraig Floyd: Why do you feel medically underwritten annuities are such a hot topic at the moment?

Paul Taylor: I believe they are a hot topic because they are quite an effective additional tool to enable scheme sponsors to chip away at overall scheme risks. Indeed, properly used, it is a tool that can knock chunks off scheme liabilities whilst also delivering excellent outcomes at a member level so it's a win-win situation.

Andrew Cheeseman: Annuities are the hot topic, and medically underwritten annuities are a refined extension of what we have not been able to do in the past for group arrangements. From an employer's point of view, if it can reduce cost it is obviously an advantage.

Andy Morley: Medically underwritten annuities are a relatively new innovation in the buy-out area and anything that is new is usually topical. The transactions that we saw in 2013 have shown that you can achieve material savings in this area without necessarily increasing the complexity of the deal or the timescales over which you complete the deal. The common quotation process that the four insurers involved have agreed on has, to a certain extent, made things smoother for the trustees and has brought forward a standardised approach to underwriting and data collection. This has been something of a comfort to those involved, showing that it isn't as complex as they might assume.

James Mullins: The pricing that we have seen on medically underwritten transactions that we have completed for several clients is very competitive. The current prices are about 10% cheaper than traditional buy-in prices, which is close to technical provisions for most schemes. This is very compelling because if you can reduce the risk for part of your scheme at these kinds of price levels, then it is potentially a great transaction for both trustees and corporate sponsors.

Pádraig: What sort of schemes are they suitable for?

Paul: From what I have seen, most DB schemes could find an application for this approach. The key is to understand your membership and whether to target an element of it. Where does the real risk sit - work that out and target it.

James: I would agree, medically underwritten buy-ins do have wide appeal. For smaller schemes, with a few hundred members, then it is a neat way of tackling a big part of the scheme's liability.

For the larger schemes, we are seeing what we refer to as 'top slicing' which involves looking at individual members with the highest liabilities where there is a big concentration of risk. The issue being that if these high liability members live longer than you allow for, it will significantly damage the scheme's overall finances . Therefore, if you can insure this group, it can have a powerful impact. More generally, if you are in a particular industry where you know that your members have been exposed to certain issues during their careers that could affect their health, then those are obvious candidates as well.

Andy: It depends on how the trustees and employers translate their scheme into one of the size categories. Some of the transactions are using a profiling technique where the advisors sit down with the employers and trustees to go through the scheme profile and come up with an answer that indicates whether they think they will or will not benefit from a medically underwritten transaction. It is a more scientific way of getting the idea over to the trustees that you can almost measure these types of things and go to the insurers well-informed.

Andrew: It comes down to the collation of data and where the risks lie. Collation of data is important because if you are going out to several thousand people, you won't necessarily get a response from everybody. Additionally, the time it takes to get everyone to respond can make things quite difficult. So if you can 'top slice', that is ideal because what people don't tend to realise is that there may be a few executives in the larger companies who account for a considerable portion of the liability.

Essentially, buy-ins are just a means for trustees and employers to come to the conclusion that they want to dispose of part of their longevity risk. The reduction of risk is what employers are attracted to, in the same way as they would be with any other annuity purchase. However, the key to the medically underwritten annuities is definitely the 10% reduction on a typical quotation one would receive. So whether it is right or wrong, it appears that in going down this route, schemes tend to come up much closer to technical provisions, a lot closer than people actually realise.

Pádraig: What do schemes looking at potentially going down the medically underwritten annuity route need to consider beforehand?

Paul: Annuity purchase projects can be difficult to pull off unless all the key stakeholders - the trustees, the sponsor, key management figures - all understand the technical challenges and the commitment that all parties need to make to ensure the project works. The advisory spend on an annuity project can be quite daunting in cash terms, certainly at feasibility study stage. Therefore, there needs to be absolute commitment to following the project through if the economic advantages become clear. Too often, trustees and sponsors will half-heartedly commission the initial work then not have the drive to follow through on the conclusions that flow from that work. The scheme trustees and sponsor need to work as an effective team with clear objectives and a timeline that they are prepared to stick to.

Andrew: You need members to understand that this is a totally alien process to their normal lives. When they are being medically underwritten, they need to tell the truth and therefore, we have to ensure that those who fill in these forms give a fair and honest perspective on their lives. We also need them to be able to understand the forms so we need to send out a short, punchy questionnaire making it clear that we are trying to establish their illnesses, not how fit they are. They are not being considered for life assurance.

James: If a scheme is potentially interested, I would urge them to begin the process as quickly as possible because there are some big advantages in being an early mover in this market. As it is still a relatively new area, those who are early to transact are likely to achieve particularly good pricing.

Additionally, scheme representatives and employers need to consider what member subgroup to focus on, for example whether to 'top slice' or not, as well as which insurance companies you want to approach, be that a request for a quote from all four insurance companies in this space or just one or two quotes.

Other important considerations are what assets to use to fund the buy-in, what impact that has on your remaining investment strategy, and what target price to aim for. And if you do have a figure, I would recommend that you are open with insurance companies about this target price that you are aiming for so that they have a challenging but clear target to work toward.

Andy: The initial phases are dealt with in the same manner that you would with conventional buy-ins which includes ensuring that the data is clean and that trustees and employers are aligned so that everyone is ready to transact. You also need to consider your liabilities and membership profiles. If they suit a transaction, then follow up with your insurance companies and think about how you will get the best response rate and data from your membership.

Pádraig: What happens if you uncover a super healthy population when seeking a medical underwritten annuity quote?

Paul: It's probably best to look at it positively as you will then have excellent management information about your scheme and the risks inherent in it. Bulk annutisation in all its forms is about dealing with the longevity issue head on and being prepared to negotiate in a business-like manner with the insurance market. Medically underwritten annuities is a growing market so I would be surprised if there still isn't a commercial deal be done with some insurer(s), even if your entire membership is fit enough to run a marathon.

Andy: Hopefully it would have been spotted in the preparation stage and a well-advised trustee and employer is not likely to have gone for an underwritten quote if this is the case. It might happen occasionally and this kind of healthy population would likely lead to a healthy price and there is no real way around this. These consequences definitely need to be well-considered by the trustees and employer very early on.

James: At the profiling stage, you need to look at what information you have already, and what information you need to seek in order to have the best understanding as to whether or not you are likely to find yourself in this situation. If there is a possibility that you may uncover a super healthy population, then it probably isn't worth going forward.

Trustees need to be aware that this risk does still exist because if you survey your population and find out that they are super healthy, you cannot ignore that information and it would have to be disclosed for future transactions.

However, as Paul mentioned, the providers are currently very keen to grow this market so the pricing for early movers will still be good. Therefore, the risks of uncovering a super healthy population are much less now than they would be in a couple of years' time.

Andrew: A typical insurance company that doesn't use the medically underwritten route will provide you with an indicative quotation. Therefore, I would expect someone who is considering this to firstly gather their data, get the indicative quote from that data, and then from there they can decide whether or not to go down the medically underwritten route. If the cost to proceed down this route is higher than you would expect, you won't go forward with it.

What the trustee and employer is interested in is whether they can do a buy-in close to what we they are reserving in their technical provisions, and if they can't do this, it means there will be a cost to the employer. The employer is therefore looking at any difference between their technical provisions and their buy-in costs, and if the medically underwritten route is the best one, then they would go down this route. However, they would get indicative quotes first. I haven't witnessed anyone receiving a quotation that is higher than the indicative quote when they have gone down medically underwritten route. It is a fresh market and people are taking a good approach to it.

Pádraig: If the interest that we are seeing in these medically underwritten annuities manifests into many more completed transactions, what impact will this have on the de-risking market place??

Paul: I see the whole annuity market evolving over the coming years. Evermore DB schemes are now closed to accrual and are thus legacy situations requiring good financial and strategic management by trustees and companies. I keep hearing that the annuity market will never have the capacity needed to mop up enough DB schemes that want to ultimately buy-out, which suggests a capacity crunch at some point. Schemes are racing against each other to get to a funding position where partial or total buy-out becomes feasible and they are putting in place investment structures to help achieve this. I can envisage a situation where dynamic investment strategies and buy-in solutions start to get closer together and possibly merge into one total solution. Certainly, en route to the capacity crunch, I expect further innovation and proposition refinement to come through, resulting in some attractive deals for those schemes that are able to get their data in order, understand what they want to achieve and communicate this in a way that gets member buy in.

Andy: It is important to educate the market place about the process in order to embed medically underwritten annuities as a standard part of the de-risking suite of tools. We want to promote this to become the norm rather than be considered as an exception. As we witness more completed transactions, it will speed up the transition that many expect to see which is that for certain transaction sizes, medically underwritten will be the only way to a buy-in or buy-out.

The only current providers in this area are the four insurers who have contributed to the development of the common quotation process. We will most likely see new entrants to the market whether that is insurers increasing capacity, or companies that specialise in gathering the data and performing the member interviews.

If we witness many more deals, it will most likely increase response rate for future deals because members will see these transactions occurring. I would therefore expect that there will be improvements in the way we approach members.

James: Indeed, the more deals that are done, the more this will become the accepted norm for buy- ins that are below a certain size. The market is relatively new but it is growing at a rapid pace so we are heading in this direction.

Looking at what has happened in the individual annuity market for Defined Contribution scheme members, there is a reasonable chance that this will be mirrored so that insurers that are gathering this health information and refining the annuity pricing accordingly can offer more competitive annuity pricing. Whereas, the pricing for those insurers that are not gathering health information is likely to harden over time because by definition, the unhealthy lives are more likely to go to insurers who are gathering health information. Therefore, what you would be left with are schemes with a more healthy population and as a result, the annuity rates for those remaining are likely to go up.

We might see the same thing in the Defined Benefit space whereby if you go to a traditional buy-in provider who isn't gathering health information, over time you might see their pricing go up as they will be worried that they have healthier than average members as the schemes with less healthy members would have transacted via the medically underwritten route.

Andrew: We are most interested in how the insurers are matching their books as we don't want someone to be more interested in their business production figures than their ability to insure. There are certain limitations in this market, but no more than the normal annuity market. But we would definitely go through the strength of the insurers' covenant before proceeding and this would be inclusive of any bias toward particular markets which were not matched elsewhere.

Pádraig: Thank you all for taking the time to share your views on the topic.

2.2 WHITE PAPER

Step by step guide for medically underwritten annuity transactions

James Mullins
Partner, Hymans Robertson

Medically underwritten buy-ins - act now to capture a rare opportunity to reduce risk at a very competitive price

Around a third of all individuals retiring from DC schemes buy an annuity that takes account of their medical history. Just Retirement and Partnership, both of whom specialise in this market, now attract over £2 billion of annuity business each year – and many of the mainstream providers also offer annuities that reflect individuals' medical history.

Until recently, this market was limited to individuals. However, with a number of recent transactions, including two of the biggest transactions that we led – the £24 million pensioner buy-in by the Institute of Chartered Accountants Staff Pensions Fund and the £22 million pensioner buy-in with Partnership that was announced in September 2013, this market is now open to bulk transactions.

It's rare that companies have the opportunity to significantly reduce the risk within their defined benefit pension schemes at a very competitive price – but we believe that the medically underwritten buy-in market currently presents exactly this opportunity. In both the cases noted, our client has been able to remove the risk in relation to their highest paid pensioners close to, or below, the level of their technical provisions. And this is not due to poor health.

What is a medically underwritten buy-in?

A medically underwritten buy-in differs from a traditional buy-in because it takes account of individual members' health details in the pricing, initially by asking members to complete a short questionnaire. Having the additional information can enable insurers to drive down the pricing. This is particularly the case if the pensioners have any health issues, but simply the absence of an unknown (medical history in this case) enables the insurer to price more competitively.

Why is pricing so attractive currently?

Partnership and Just Retirement both started off in the DC market and they have now expanded into the DB market, with both companies seeing this as a strategic growth area. The companies have years of experience of factoring in individual health information into their pricing. Furthermore, these companies' desire to transact means that, for the time being, deals can still be very attractive even when scheme members are, on average, in reasonable health.

Our sense is that there is capacity in the market at current pricing levels but that this can't last forever.

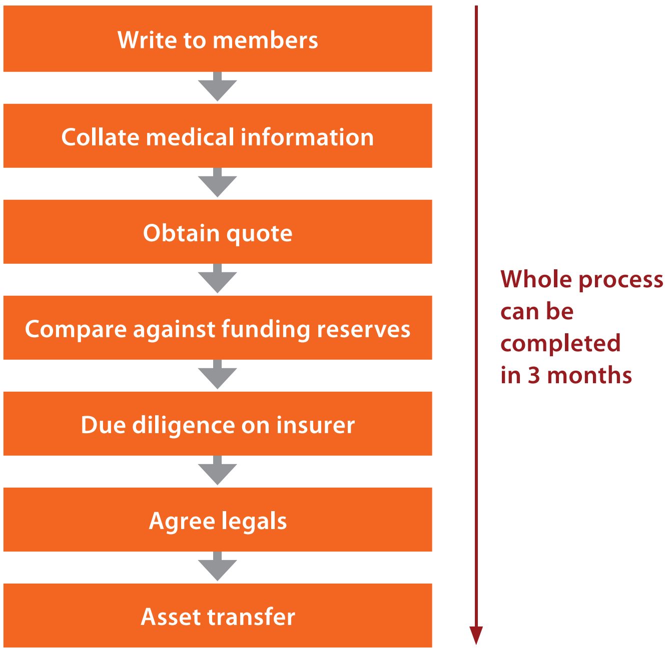
Who should consider this?

While the insurance companies have streamlined their processes, medically underwritten buy-ins are not suitable for very large numbers of pensioners. The typical size might be up to 50 pensioners, although it would be feasible to deal with larger groups of pensioners (up to say 500) although perhaps with only some pensioners being subject to full medical underwriting. The ideal scheme is one with liabilities of up to around £500 million where there is often a concentration of risk among a few high liability pensioners.

How do I transact?

The transaction process is very similar to a traditional annuity purchase, and can actually be quicker and cheaper because of the smaller number of members covered.

The response rate from pensioners being asked to provide health information is surprisingly high, typically over 90%, perhaps as they recognise the additional security that a buy-in of this nature will bring to all scheme members.



Top tips for companies
• Rank your pensioner liabilities by size – it's easy to do and will demonstrate the risk concentration in your liabilities and hence whether a carve-out of your high liability pensioners will enable a significant portion of your liabilities to be hedged.
• Think about your high liability pensioners – they may well be known to the company, meaning you will have an inside track on whether they have any health or lifestyle conditions that would be reflected in medically underwritten buy-in pricing.
• Use an objective method to select the pensioner population (e.g. by pension size or liability), and buy annuities to back all these members. Don't just buy annuities to back the unhealthy lives as this will come back to bite you in future buy-ins, or simply in your ongoing scheme funding.
• Be wary of getting a medically underwritten quote if you are planning a traditional buy-in purchase in the next few years – traditional providers may increase their prices if they know you looked into medically underwritten annuities recently and decided not to proceed.

The annuity market has evolved considerably over the years from basing annuity pricing simply on age and sex, through to the use of post codes and pension amounts, and now to the use of medical history. We welcome this latest innovation in offering increased choice to companies to manage their pension risks.

James Mullins, Partner and Head of Buy-out Solutions, Hymans Robertson

James Mullins is a Partner and Head of our Buy-out Solutions team. He has 15 years' experience of advising defined benefit pension schemes and has specialised in buy-in and buy-out transactions for the last seven years. As a Scheme Actuary and corporate adviser, James has a strong appreciation of perspectives that each stakeholder has and specialises in bringing all parties together to reduce pension scheme risk for the mutual benefit of trustees, companies and, most importantly, pension scheme members.

"The response rate from pensioners being asked to provide health information is surprisingly high, typically over 90%. . . "

Trustee Tales

Ready for whatever risk throws your way?

When our partner Crawford Taylor entered a charity cycle race with friend and client Gregor Alexander of SSE they didn't stop to consider that bad luck comes in threes.

So when Gregor got three punctures in a row, the pair could have been excused for giving up. Instead, they called in the help of the SSE support vehicle, got back in the saddle and finished the race.

And that's just the way it is with Hymans Robertson. We work as a team with our clients. We plan for the worst. And when times get tough, we dig in. Take our risk management work for SSE. Back in 2003 we put a strategy in place for their pension fund. A decade of general uncertainty followed but SSE weathered the storm remarkably well. In fact, our plan helped deliver significant benefits to scheme members through increased benefit security – and to shareholders and customers through controlling contribution requirements.

No one knows what's around the next corner. But with the right partner, you'll always be prepared. Call Crawford on 0141 566 7932 to find out more.

Watch the Trustee Tale film at
hymans.co.uk/trusteetales

2.3 INTERVIEW

Why a traditional buy-in was the best option

Interviewer

Chido Tagarira
Senior Publisher, Clear Path Analysis

Interviewee

Scott Blurton
Group Pensions Manager, Home Retail Group Pension Scheme

Chido Tagarira: What were the drivers behind the Home Retail Group's decision to complete a pension buy-in?

Scott Blurton: It was mainly the opportunity to de-risk the pension portfolio. A few years ago, the scheme trustees took a strategic decision to seek a move to a full buy-out in the medium-term when affordable. This is being done using a combination of any appropriate possibilities that come along, such as attractive pricing in the buy-in market, and by also de-risking our investment strategy.

In terms of the micro detail in respect to the decision to complete a buy-in, essentially we looked at the buy-in pricing in comparison to the technical provisions of the pensioners and also the portfolio that the scheme held. The scheme had a significant portfolio of gilts and a portfolio of Super Nationals like Network Rail that are essentially gilt-like assets. With the gilt yield where it was, the scheme had done quite well in terms of the performance of those assets in cash terms. Therefore, when we looked at the assets and the value of the technical provisions in comparison to the cost of the buy-in, we were able to undertake a buy-in at low to nil cost compared to the technical provisions. Essentially, we were exchanging certain risks associated with the scheme and longevity risk was the primary one. The buy-in has provided us with longevity protection, at zero cost compared to the technical provisions.

Chido: Was timing a factor in this?

Scott: Absolutely. It was the timing of the yields and the buy-in pricing that enabled the buy-in to occur. If it would have created a deficit by the fact that the pricing of the buy-in was more than our technical provisions, then we wouldn't have been prepared to undertake the transaction.

Chido: Did you look at other potential de-risking options at the time?

Scott: We did look at a liability driven investing (LDI) strategy to try and hedge away as much of the scheme's risk as possible.

When thinking of buy-in or de-risking pension risks, schemes have the option of:

- LDI, which has the potential to benefit from future effects such as yield revision if any kind of mismatch between the LDI strategy and the liabilities exist. But it has downside risks of the liabilities increasing faster than the LDI strategy as any mismatch can work for or against
- A buy-in which has the advantage of locking in at a price and having no mismatch to the liabilities and thus lower risks, however a buy-in does not have the potential to benefit in the future as it gives up upside potential for certainty that downside risks will not occur

For example, if the actuary has got it wrong and the technical provisions are overcautious, schemes can benefit from the unwinding of this cautiousness in the future. With a buy-in, schemes lose this opportunity but the advantage is that if the technical provisions are too light the scheme would not suffer any loss in respect of this.

Chido: Is there anything you might have handled differently during the process?

Scott: Data is a big element with a buy-in transaction. If a scheme is not fully in control of data, they may end up in a difficult situation of not being exactly sure what is being insured. Our provider was able to provide us a "data window" in which to cleanse our data after we had signed the deal and I'd recommend schemes thinking about a buy-in to consider this.

The transaction process ended up being longer and more convoluted than we would have liked. It took about 10 months to go from start to finish, as there were periods when the pricing didn't meet the scheme's criteria. Ideally, I would recommend an automated mechanism so that once their criteria has been achieved, actions can quickly follow as opposed to constantly having to meet up to discuss pricing. However, knowing where exactly to set the criteria and achieving best execution pricing is challenging.

Chido: Did you have sufficient advice and support from the service providers in the marketplace?

Scott: We were happy with the role that our professional advisors played in this. However, with the insurers, we felt that there was a bit of a divide between those who were more open and transparent with pricing and those who were more commercial. Those who were open would give us the relevant index so we were able to follow their pricing whilst others would give us one day's price and we were never able to get a grip on how they were moving without the assistance of our professional advisers.

Chido: **How has the buy-in been beneficial to the members so far?**

Scott: When we consider what the pricing would be now compared to what we paid (i.e. what our liability would be in respect to those individuals) then it is above any investment performance that we could have achieved. We would have had a larger deficit than we have now if we hadn't done the buy-in.

We have locked down over a third of our total liability for the scheme to the point where we have an easy task monitoring this part of that liability as the buy-in price moves exactly in line with the liability it supports.

Chido: **So has this allowed you to focus on other parts of the scheme?**

Scott: Yes it has. The value at risk (VaR) of our investment strategy has come down which is good news for our sponsor as it is less likely that they will have to put some cash up to deal with any future deficits. It's better for members as well.

Chido: **What advice would you pass on to schemes that are considering going down the buy-in route, including those that are looking at the medically underwritten annuities?**

Scott: Ultimately, buy-ins and buy-outs, including medically underwritten annuities, are where the market is going. A scheme that is closed to new entrants or to future accrual doesn't have an infinite life. This scheme is ultimately winding down and how quickly this happens, be it 30-60 years down the line, makes no difference. Buy-ins and buy-outs are good tools to assist schemes in this winding down process.

Of course there are risks and pitfalls so making sure you partner with the right people and ensuring that you are comfortable with their covenant are important. You are locking yourself in for a long period of time so you have to be aware of the risks associated with that, but provided that you do understand the risks then buy-ins are useful assets that can help you move towards your ultimate goal, or paying all benefits due in full, and on time.

Chido: **Thank you for taking the time to share your insight and experience with this,**

"when we looked at the assets and the value of the technical provisions in comparison to the cost of the buy-in, we were able to undertake a buy-in at low to nil cost…"

SECTION 3

THE NEXT STEP: ACTIVE MEMBER BUY-OUTS

EXPERT DEBATE

Are active member buy-outs likely to have a significant position in the future de-risking market place?

EXPERT DEBATE

Are active member buy-outs likely to have a significant position in the future de-risking market place?

Moderator

Sam Brodbeck
Reporter, Pensions Insight

Panellists

Alan Taylor
Former Senior Manager, Human Resources, DENSO Europe (2003-2013)

Rosemary Kennell
Director, Capita Pension Trustees

Sam Brodbeck: What makes an active member buy-out appealing?

Alan Taylor: I have been involved in this from both a company and trustee perspective. For some companies, active member buy-outs are certainly an interesting and appealing option. The active member buy-out transaction wasn't the original intention of DENSO when we went into this project. DENSO went in to reduce the risks around the final salary pension scheme liabilities which had been profiled globally and the UK scheme had been flagged up as the area of greatest concern.

Although we didn't go into this with the mindset of doing an active member buy-out, we learned a great deal through the process. As Trustees, it was about balancing the interests of the different member groups. The company had approached the trustees with a strong desire to get risk off the table and they were looking at deferred and pensioner members so put a lot of cash on the table to secure these benefits. The Trustees were then asking about the active members, which is where the active member buy-out option became essential as we wanted to treat each of the member groups consistently.

Rosemary Kennell: I would question whether active member buy-outs are appealing because, from a trustee perspective, they tend to be something that an employer would want as a means of getting this risk off the balance sheet. In the long run, they are likely to be very expensive for an employer to do because although you have secured the benefits for past service, you would have a different position for active members. For actives members, you would presumably have to buy an extra triage for another year's service and salary increase. This might become quite expensive because you are committed to your one insurer who might in future years not be as competitive.

Going back to the 1970s, we used to have deferred annuity contracts for pension schemes, which is what active member buy-outs appear to be. I can understand why it was done for DENSO but I can't see it being overly popular with many other schemes in the future.

Sam: I suppose the obvious negative is that it is very expensive to do an active member buy-out so for many companies it isn't going to be viable.

Alan: It depends on how it is structured and how much risk you insure. When our active member buy-out was being constructed, there was a great deal of flexibility with the insurer to structure the risk level, and therefore the premiums, according to the interests of the principal employer. DENSO wanted an all-risk approach with all the ongoing costs going away, but this couldn't be done in real terms. When you have an ongoing insurance product locking in ongoing yields of accrued entitlement for active members, there will always be a premium to be paid, and adjusted for, at the end of each fiscal year where you look at how many people you've got employed and the salary growth. There is greater flexibility than people think to potentially make these buy-outs more affordable, but in basic terms you have to put cash upfront to reduce the pressures downstream to close funding deficits. This was where DENSO finally decided that it was a good approach as over the years DENSO had been repeatedly asked for capital injections to its UK pension schemes with funding gaps continuing to get larger at each actuarial valuation. DENSO had lost confidence that the actuarial valuations were being managed in a way that would prevent it from having this continued exposure to very large sums of money being required to secure its final salary liabilities. The choice it had was to close its schemes fully, wind up the schemes and shut down the future accrual. But due to the circumstances of its business in the UK, DENSO valued the longer-term service profile of its active employees who had the knowledge, experience and stability. This key benefit for the longer serving portion of its workforce was substantial in the justification for an active member buy-out as a crucial factor for the business. There was a particular uniqueness to the DENSO approach and what we needed to get out of it which is what made this solution worth constructing.

Rosemary: You were lucky that the sponsor had the money because for many schemes in the UK, the employer does not have spare funds to do this.

For the active members, are you not paying an adjustment if anything changes in future years? Have you

"There is greater flexibility than people think to potentially make these buy-outs more affordable..."

completely bought it all for their future service?

Alan: No, there is an ongoing adjustment which takes into account salary increases and there is a complex formula for pricing this out with the insurer. In theory it could be up or down in terms of the overall costs, so yes there is an ongoing cash requirement each year to effectively secure that entitlement and locking it down.

Sam: **Normally with buy-ins or buy-outs, the company wants to know that they are going to pay a fixed price and then that is it. How does that premium change year by year?**

Alan: This transaction took place in March 2012 and it is an annual adjustment. As we are just coming to the end of the second year, I can't say for certain how much it changes by each year. It is still a significant amount of money and there is still a risk of this spiking depending on what happens in the market.

Sam: **Most people who de-risk want the certainty but it sounds as though they are retaining some risk?**

Alan: Correct but looking at the bigger picture, it appears to be a far smaller number, and the overall risk is far more contained than DENSO would have been exposed to from each actuarial valuation cycle.

Sam: **Did the fact that a foreign parent approached the UK make them more inclined to go down this route as opposed to a UK-based scheme?**

Alan: As a Japanese company, they value different things and in particular employee service and motivation. However, it was driven by a financial rationale which was that they didn't want to be exposed to these big swings in numbers and wanted to get all of the risk off the table. It wasn't the starting point though. The starting point was to challenge actuarial valuations and make sure that they were well structured, robustly managed as well as looking to reduce the deferred pensioner liabilities, so an enhanced transfer value exercise was also conducted. It was only in the final stages, around 6 months before the active member buy-out actually took place, where we wondered if there was a way to also secure the active member element of it.

Sam: **How does it differ to the traditional deferred member buy-outs?**

Alan: There are differences and you do need to consider the future benefit accrual, pension salary increases and how you manage member contributions. Additionally, there are also many other complications around life insurance and the other benefits that can get tied up with final salary pension schemes as you are still effectively offering a pension-like benefit for the employees.

The fundamental principles between an active member buy -out and a deferred member buy-out are the same. However, with an active member buy-out, it is about how you lock in future salary increases and how stable the workforce is.

Another difference between the more conventional deferred member buy-out model and the active member buy-out approach is that with the latter, you will need to consider what point you take the trustees out of the loop. The DENSO scheme is now in a wind-up process and the trustees will be discharged by April 2014. The employer then may have ongoing issues around governance and satisfying the employees that this annuity will be reliable as the trustees have no responsibility for it any longer.

Rosemary: There is also the issue that for the active members, the employer will be paying premiums to the insurer for many years. Although you would hope that all is well with the insurance company in future, and that you are protected by the financial services regulations, insurers can come and go.

Presumably, each member will also have individual policies and the benefit of a buy-out, when the scheme has finally wound up?

Alan: Yes they do. All of the policies have been issued and there are clauses within the policy statement to look out for the future continuation of that benefit.

Rosemary: If any member leaves, presumably they will automatically be treated as a deferred member?

Alan: Correct.

Sam: **What have you been doing since the transaction was completed in 2012?**

Alan: As of March 2012, the scheme was able to move into wind-up because all of its benefits had been insured. Since then, it has been a conventional wind-up project whereby we have been identifying any members who had fallen off the grid, looking at reconciliations with the guaranteed minimum pension (GMP). In addition to that, we have been navigating the many technical and administrative issues in transferring the payroll for the pensioners across to Mercer who are now contracted by the insurer. It was a lot of work to identify every member and benefit, and ensure that it was all locked away properly.

Sam: What advice would you give to any trustee considering an active member buy-out?

Alan: It is essential to be very clear on what you are trying to achieve as well as the cost and complexity. It was terribly complex, mainly because it hadn't been done before and we also had multiple parties (which included the two UK pension schemes and therefore two sets of trustee boards, scheme lawyers, actuaries, and company representatives). You also need to be very clear about how much risk you want to take and how much risk you want to insure.

Additionally, you need to be thinking forwards. Traditionally trustees have to look 50-60 years ahead to the funding and deficit cycles to see whether they can fully provide the benefits that their members are entitled to until the last member dies. This product changes this and it is about securing all of the members and effectively giving everyone an annuity. It is just a different mindset and it takes time for both the trustees and the sponsoring employer to fully grasp what this actually means.

The other elements to be aware of would be to ask how important future accrual is to the employer and how much are they willing to pay for that. There are some companies with large unionised workforces with final salary schemes, so this could be more appealing to them if they have the cash to be able to take such decisive action to secure all benefits in this way. So you could keep the union goodwill as well as the employee loyalty and motivation because they would retain this prized final salary benefit.

Good advice is also imperative and you need to push the insurers to be flexible.

Rosemary: I suspect that for other schemes, employers are finding other ways of giving the active members future service benefits by buying out the old scheme and effectively setting up a new one for a small number of members. This way would probably work out cheaper.

Sam: Are you suggesting closing up and setting up an exclusive new scheme whilst still using Defined Benefit (DB)?

Rosemary: Companies are not setting up new DB schemes nowadays but that doesn't mean that they shouldn't, they are just put off by the regulations and the costs involved. If you have a large, mature scheme with many deferred pensioners and with less active members, then you can buy out the active members' past service benefits revalued with future salary increases, or CPI, or a fixed increase, and then have a smaller scheme which will not appear as "bad" on the company's balance sheet as it will just relate to future service benefit for active members. This is another way around because employers could choose to reduce costs, especially UK employers who are concerned about costs. I am not aware of any other schemes that have gone down the active member buy-out route probably because of the cost element.

Alan: I'm not aware of any either. The DB area is declining and so it is ultimately in the hands of the insurance industry as to whether they think this is a useful and viable tool to help manage the future costs associated with the remaining DB schemes. It is potentially in their interests to find alternatives and innovative variations on this model to be able to offer trustees and sponsoring employers something that is more affordable than this particular model was at the time.

> "for many schemes in the UK, the employer does not have spare funds to do this."

Rosemary: There seems to be an increase in activity in the buy-out market. The insurance industry does not have enough assets to insure against every scheme. This means that it has to be a long-term project. If we have spells where they are not as busy or not receiving as much conventional business, they might start to consider many more alternatives.

Sam: Thank you for taking the time to share your insights on this.

SECTION 4

HEDGING LONGEVITY RISK

ROUNDTABLE

To hedge or not to hedge: what are the merits of a longevity hedge versus retaining capital within the sponsor to fund further business growth?

To hedge or not to hedge: what are the merits of a longevity hedge versus retaining capital within the sponsor to fund further business growth?

Moderator

Sam Brodbeck, Reporter, Pensions Insight

Panellists

Henrietta Tait
Head of Capital Management, LV=

David Nuttall
Pensions & Benefits Manager, Allianz Insurance

Goldie Murray
Trustee Director, National Grid

Sam Brodbeck: Why do schemes choose to hedge? What benefits can be derived from completing a longevity hedge transaction?

David Nuttall: Longevity hedges are for pension schemes that are seeking certainty and less volatility in their funding position. From a business perspective, it can enable the scheme to have more stable cash flows. Over the years, we have witnessed that liabilities have been going up, in some cases by around 20% over the past 10-15 years, which is down to the changes in longevity. Trustees are looking for the certainty and that would be the main reason why they would look to hedge.

Henrietta Tait: In the first decade of this century, the expected improvement in longevity jumped very materially so when assumptions for future longevity were updated in triennial valuation process, there were substantial increases in liabilities. Whilst it is probably not expected that this rate of improvement would carry on indefinitely, in reality there is quite a wide band of possibility as to how quickly it will actually reduce. So pension schemes wanting to hold a buffer to cope with this and to avoid volatility in the future, longevity swaps could be the answer. This is especially true as many schemes are facing one-off jumps of increase in liabilities by 10% or more and say even up to 20% over the coming decades, so being able to take out this range of uncertainty is obviously very beneficial.

Goldie Murray: I will be speaking from a personal viewpoint, not as a representation of the National Grid, or my fellow trustees' perspective on the subject.

Taking risk out of the scheme is an element that most trustees want but you need to keep it in context in that you need to work out what the risks are that your scheme is facing, and what percentage of that risk does longevity amount to. Whilst I agree that it is good to try and take this risk out, there are other risks which may be more pressing for the scheme that you have to consider.

Henrietta: Longevity is one of the harder risks to hedge out and if you get into a position where there is an opportunity to do it and it makes financial sense, then it is probably worth going for.

Sam: Henrietta, how has completing a longevity hedge benefitted the scheme so far?

Henrietta: We completed the longevity swap in 2012 and as scheme sponsors, we were very heavily involved. One of the features of the hedge that we put in place was to hedge out a certain amount of the risk on the deferred life as well, and this was the first time that it wasn't just the in-payment life. All in all, we covered about 70% of the valuation and liabilities.

It was beneficial because it reduced the volatility. From the trustees' point of view, another benefit was that they had some certainty around future accruals for the vast majority, and from a sponsor's point of view it meant that what can be a tricky part of the discussion (i.e. how much margin should be allowed in the valuation assumptions) goes.

The longevity swap has served as part of an overall de-risking program. We are not trying to fully de-risk but we are aiming to take out other risks such as interest rate and inflation risk, whilst also getting some certainty over the cash flow profile. We have a fixed swap in place which means that it enables us to make these other hedging activities much easier.

Sam: Do you know what would have happened if you hadn't put the swap

in place, where would the scheme be now?

Henrietta: It was largely about de-risking so we would have been further strengthening the longevity assumption, which is why from a sponsor's point of view; it has already been worth it. It varies from sponsor to sponsor but, in our case, the sponsor is of course an insurance company with a regulatory regime where we have to hold capital for all of the potential liabilities, including those coming from the employee pension scheme. Therefore, the longevity swap has resulted in a reduction in the capital that we have to hold for that risk, but whilst that is not cash flow, it is still a win-win scheme.

Goldie: Was the scheme fully funded when you undertook this exercise?

Henrietta: The scheme was close to being fully funded on a technical provisions basis. There is going to be a cost and a margin over what one sees as a best estimate, but it is then a question of what margin the trustees need in the technical provisions basis compared to a best estimate.

Goldie: Did you hedge all the longevity liabilities, or just a particular portion of your members?

Henrietta: The hedge covers all the in payment lives and a proportion of the deferred lives- those in the mid-50s and over. We wouldn't have been able to get the active lives and there is a cut-off at which our swap was 53 years. When we were looking around the market, I certainly don't think anyone would have quoted at that point for much lower ages.

Goldie: What was the rough number of people who were hedged?

Henrietta: The scheme has £1.2 billion of assets and about 70% of the liabilities are hedged.

Sam: Given the merits that can be derived from a longevity hedge, what is currently restricting schemes from completing transactions?

David: As it is a new market, it can be difficult to assess value for money. When it comes to pensions in payment, there are two sorts of risks to consider, one being financial risks like interest rate and inflation risk and the other is demographic risk like longevity. Interest rate swaps are traded all the time and it is a well-established market with a clear pricing structure. Whereas, longevity swaps are far more infrequent so it is harder for trustees to feel comfortable that they are getting value for money and for them to go into transactions that they fully understand.

The other issue is that in the pensions industry, there tends to be a herd mentality with many schemes not wishing to be the first in as they want to see what other schemes are doing first, and then they may feel comfortable to proceed. I think it is going to be a snowball effect and as more schemes transact, the pace will accelerate. For now, it is just a question of getting going.

Henrietta: I would agree and one of the issues here is that there is a minimum size because just at the negotiation stage, there didn't seem to be a standard form of contract. Negotiating the contract can take many months as it is bespoke and, in our case, certain amounts of the negotiation was around the deferred lives where the data issues were much harder to have full clarity on. It is a significant one-off cost to put this in place.

"longevity swaps are far more infrequent so it is harder for trustees to feel comfortable that they are getting value. . ."

Goldie: We were at the opposite end of that scale as we found that because of the size of our scheme, we would have been an aggregate more than the combined market put together. We were going to have to split it up amongst a whole host of providers. And because it was not clear what lives they were insuring, they would have all been acting against us.

Henrietta: I completely understand that because there is a finite capacity so if providers have reached their capacity limit, they aren't prepared to quote.

Goldie: We found that most of the quotes that we got were for only a small portion of the liabilities so we couldn't have hedged all of them anyway as the market was too small to accommodate it.

Sam: Is there a problem more generally in terms of insurer capacity for this? There seems to be a bit of a window at the moment as reinsurance around the world is trying to balance out the risk of life insurance with pensions.

David: I agree with that and it is looking to offset that mortality risk which is driving the opportunity at the moment.

Goldie: We certainly weren't aware of that when we looked at it, but the issues we faced were to do with size.

Sam: So for you it wasn't worth insuring a tranche?

Goldie: We considered it, but it is then trying to work out what tranche to insure and the downside of that, in relation to other people who are not being insured potentiality thinking that they are somehow in a lesser position. We couldn't even insure all pensioners for example, so it was impossible to decide how you would split it up. We would have been happy to work through it, had it been beneficial on the actual metrics on the quotes that we were getting. But, the cost of reducing that risk didn't look favourable when compared to reducing the risk on a much stronger basis if say the sponsor was willing to put the same amount of money in, and that money was spent on some of the other risks that the scheme was running.

Sam: Is there a case for retaining the capital within the sponsor to fund further business growth rather than going through with a longevity hedging transaction?

Henrietta: There is a case for this and it depends on what you are going to pay for the hedge and the cost-benefit analysis. In our case, it was well within our cost of capital criteria which then freed up capital for the sponsor. The difficulty here is the potential uses for that capital. How the sponsor wishes to deploy it and what the cost of capital criteria is will vary so there is absolutely a case that at some point, the hedge might just be too expensive.

For the very large schemes, they may find that what they can actually hedge out at a sensible price isn't going to make any difference anyway.

What you get from the hedge is the certainty, so you aren't sitting there holding the capital because in 10 years' time you may have a 10% increase in your liabilities. So being able to take out nasty surprises from the scheme may well help discussions with trustees of the scheme about keeping these schemes open or being closed to future accrual etc.

Sam: What is your view on longevity index trades? Will they gain much traction in the near future?

David: It has the advantage of being simpler as it tracks movement in the longevity index rather than a bespoke approach which is customary. However, it is a very new market and whether changing structures are clear and people understand it is rather subjective.

Henrietta: One of the problems is the basis risk. It might help smaller schemes because everything doesn't have to be absolutely bespoke, but the difficulty is that in a smaller scheme, you are likely to have more volatility. So it may just exaggerate the problem and I'm not so sure how much comfort it would give the trustees.

Goldie: One advantage of having a large scheme is that your member experience is statistically significant, so we would modify the longevity tables with our own experience in the scheme which removes a lot of the swings that you sometimes get. It also means that you are dealing with a spectrum of lives as well. But interestingly, we have found that whilst the age profile of the liabilities is very much in accordance with the table, it is skewed towards higher earners living longer.

Sam: Thank you very much for taking the time to share your insights on this.

"the cost of reducing that risk didn't look favourable when compared to reducing the risk on a much stronger basis. . . "

SECTION 5

DATA AND TRUSTEE EDUCATION

5.1 WHITE PAPER

Is inefficient data restricting transactions?

5.2 INTERVIEW

Do trustees have sufficient knowledge to make the call on whether or not to do a buy-out, buy-in or longevity hedge?

5.1 WHITE PAPER

Is inefficient data restricting transactions?

Darran Blount
Director, ITM Limited

Spencer Wyer
Group Chief Technology Officer, EDM Limited

Pension data has come sharply into view as organisations approach the insurance market for de-risking transactions. Can you see what's hidden under the surface of your pension data?

Those considering a pension de-risking solution know that a good outcome depends on the quality of pension data supplied to insurers. In many cases, insurance companies have been rejecting poor quality pension scheme data or simply inflating premiums to cover uncertainty. Some have made a start on the problem by digitising pension documents, but few have managed to actually extract the data they really need from these documents. Therefore liability transfer opportunities are still at risk. Add to this the inflated costs of ordinary pension administration due to data gaps or errors, and we suddenly see a great deal of unnecessary risk and cost.

Digitising data can be a smart first step. But swapping paper for digital hasn't solved the underlying problem if the digitised material isn't properly accessible, analysable or integrated.

This problem will become immediately clear as the organisation starts approaching insurers to de-risk. By that time it's usually too late to avoid missing the narrow window for favourable transactions or paying inflated premiums, because thorough data cleansing and preparation require significant time and resource.

So the message is clear: prepare early, correct missing or inaccurate data, and be ready to act when the time is right.

Why should trustees care about data quality?

We're often asked to illustrate in practical terms how poor data quality affects liability transfer cost as well as ongoing cost. We offer scenarios like these:

- Member information, for example spouse marital status and age, will impact pricing in a buy-out. If this information isn't available as accessible data, it's not possible to quote accurate premiums and insurers are likely to inflate premiums, or decline to offer
- If Guarantee Minimum Pension (GMP) benefits are incorrect, members might be under- or over-paid; over time this can add up to tens of thousands of pounds, having a significant impact on cost

- If pension element splits aren't consistently recorded, members can be misquoted on retirement
- Since 1990, pension schemes have had to provide equal benefits for men and women. If the equalisation process wasn't handled correctly, there may be significant under- or over-payment

So those concerned with the cost or valuation of a pension scheme, and those considering liability transfer, should weigh up the cost of inaccurate pension payments, the cost of losing a favourable insurance deal, and the cost of inflated insurance premiums, against the relatively modest cost of professional pension scheme data preparation.

And what about accessibility?

- Frequently, spouse contingent benefits aren't recorded on administration systems. It's sometimes possible to obtain original retirement statements from the late pensioner's spouse, but this is risky and time consuming (in other words, costly)
- When a member retires, it's common for administrators to read through back files comprising hundreds of pages; this manual process incurs significant time cost and can introduce human error which leads to further direct and 'snowballing' costs
- If information is locked away in paper and fiche, it is difficult and costly to extract when it's needed. But even worse, there's a great deal of information that simply isn't accessed, understood or used. As the saying goes: "you don't know what you don't know."

In this scenario, consider the lost opportunity to reduce cost based on full and accurate information, the cost of human time and resource spent manually locating and reviewing information, the cost resulting from human error that leads to premium over- or under-payment, and the cost of error-correction.

The solution

There's a common assumption that digitising pension records using optical character recognition is sufficient – this needs to change. The real solution runs far deeper and tackles problems that often organisations don't even know they have.

To facilitate accurate and efficient day-to-day administration, and to fully prepare for liability transfer, requires thorough data preparation: sourcing, digitising, extracting, analysing and cleansing pension data.

Intelligent capture, to digitise data from any source

Digitising information locked away on microfiche and printed or even handwritten paper records can make data visible and

> "swapping paper for digital hasn't solved the underlying problem if the digitised material isn't properly accessible, analysable or integrated."

> "insurance companies have been rejecting poor quality pension scheme data or simply inflating premiums to cover uncertainty."

assessable, preparing the way for making it searchable and interrogable with eDiscovery tools.

With today's technologies and expertise, it's possible to transform a manual, arduous and costly process with no guarantee of success into a digitised and automated process with improved timescales, costs and outcomes. This means more detail, more accuracy, more intelligence, and the ability to act fast.

Cleansing the data – a logical process

A cleansing process involves analysing data, identifying gaps, and correcting and calculating where necessary.

Intelligent cleansing is best undertaken using a blend of technology and human attention. A robust cleanse plan starts with a broad assessment that increasingly narrows its focus, to identify areas in the data that most need attention. Once data priority has been established, the next step is to carry out automated derivation and correction based on predetermined criteria, and bulk updates using trusted data sources like HMRC returns or employer payroll files. Many areas can be addressed in parallel for maximum efficiency.

Efficient data access and analysis using eDiscovery

Once the lion's share of data has been cleansed using automation, it's time for experienced administrators to review the remaining complex data still requiring correction or calculation. eDiscovery is the technology that makes this process fast and cost effective, creating a dynamic pension knowledge base and leveraging it to analyse, cleanse and manage.

eDiscovery draws data from a range of sources and can join current and historical records from multiple systems (for example pension, payroll and HR), for a holistic view that allows intelligent searching and analysis. Output can be graphs, charts, trends, or answers to questions about specific member data.

With saved searches, it's possible to eliminate most of the costly manual search and review time involved in answering all the standard questions asked whenever a member retires or other significant events occur. At the same time, human error is eliminated.

When it comes to more detailed or ad hoc questions, it's possible to find answers in a fraction of the time that would be spent manually searching through paper and microfiche records – which can take weeks or months.

In this context it's useful to describe eDiscovery as a 'search engine for pension data' and it can radically change the way organisations find answers to questions about their pension data.

Smart data

After thorough data cleansing and analysis, there may still be instances where information remains incomplete, and this must be flagged for future attention when more information becomes available. There must be adequate ongoing processes and controls to ensure data quality is maintained.

The key is to end up with 'smart' data that can be used to highlight problems and opportunities, accurately value the pension scheme, and provide all the detail required by potential insurers.

Using clean, smart data to reduce cost

Investing in pension data quality reduces risk and cost. We recently completed a project where reconstruction of spouse benefits reduced funding liabilities by £19 million. In another case, a leading buy-out firm reported a 30% error rate in data, resulting in liabilities being undervalued by 5%. Putting this in context for a fund of £200 million, a data risk premium of 5% amounts to £10 million, which outweighs the cost of data cleansing by many multiples.

Conclusion

At the very least, Trustees should talk to their advisors about clear and reliable pension scheme data that will enable insurers to offer accurate and favourable premiums, and also help pension administrators maintain, analyse and manage information to maximise efficiency and reduce cost ongoing.

In-house pension administration teams might already be implementing some components of the solution, but the depth of expertise required might not be present.

For a total solution, it makes sense to approach a pension data service provider who can deliver the end-to-end solution from intelligent capture and eDiscovery, through to cleansing, analysis and de-risk preparation.

"There must be adequate ongoing processes and controls to ensure data quality is maintained."

Pensions Data Management Services

5.2 INTERVIEW

Do trustees have sufficient knowledge to make the call on whether or not to do a buy-out, buy-in or longevity hedge?

Interviewer

Chido Tagarira
Senior Publisher, Clear Path Analysis

Interviewee

Philip Mendelsohn
Former Director, Atkins Pension Trustee Limited

Chido Tagarira: What is the trustee's role in a buy-out, buy-in, or longevity swap transaction?

Philip Mendelsohn: The trustee's role in this is no different to a trustee's role at all times, which is to ensure that whatever is done, is done within the terms of the scheme rules, and is in the best interest of the whole membership. The sponsor's role is often to provide a capital boost to enable the transactions to take place but that doesn't mean that the trustees should just accept it as they have to form a judgement as to whether or not the deal on the table and any additional capital provided is in the best interest of all the members, not just certain sections. Whenever you are doing something which affects a certain group of the members, you need to ensure that it is fair and equitable.

Chido: Are there any additional duties when considering a bulk annuity transaction for a smaller scheme than you might find with a larger scheme?

Philip: With smaller schemes, particularly in a buy-out where you are transferring the risk to the insurer and taking people out of the scheme's membership, you need to be very careful that you are not undermining the viability of the remainder of the scheme. Again, you must ensure that the deal is favourable to all the members, not just those who are going out of the scheme. From the insurance company's viewpoint, they are hopefully signing up to replicate the benefits that the scheme offered but that could be jeopardising those members who are remaining in the scheme.

It is much more likely that you could be at a critical point with a small scheme than a large one, because with a larger one, you are probably not taking out such a huge chunk of the members and the scheme that is left will have reasonable scale, funds etc. to carry on.

People talk about buy-ins and buy-outs as a kind of catchphrase, and they are viewed as almost the same thing when in fact they are very different. With a buy-out, you transfer the risk and responsibility of that tranche of the membership to the insurer and you have to say goodbye to them. With a buy-in, you are annuitising a revenue stream that is related to a particular group of members. This is a stream that goes into your general revenue and the money isn't dedicated to that group of members, it is simply a deal that you have done on their lives. The options will be appropriate in different situations. The smaller scheme has to make sure that they are getting value because the advisory costs are almost immaterial to the scale so the smaller the deal you get, the more expensive it will be in terms of overhead costs.

Chido: Is it the case that the smaller schemes may not have advisors readily available as perhaps the larger schemes do?

Philip: Smaller schemes are likely to have less well-equipped boards with heavyweight independent trustees who have a wide variety of experience and who are less likely to be under greater pressure from a sponsor to do a deal. In smaller schemes, you often have a group of directors of the scheme who are also directors of the company - almost swapping hats - which can make this extra challenging. Sponsors have an entirely different set of goals to the trustees.

Chido: Do you feel trustees have sufficient knowledge to make the call on whether or not to do a buy-out, buy-in or longevity hedge?

Philip: In most cases, when they begin the process, they don't have the sufficient knowledge. However, a good board with a strong chairman will explore this further and get the information that they require; this will perhaps come from the actuary or even from the sponsor, but you don't just start diving in with advice. The decision to explore a buy-in or buy-out should not be a surprise as boards should have already discussed whether this type of deal is a good idea and have visibility of it coming, so that they have time to get educated through attending conferences or in-house training sessions.

Independent trustee experience should bring some knowledge and help trustees identify what they need to learn. This then needs to be built into any timeline. They should not be tempted into acting whilst the market is "hot" because if they don't have the right knowledge to take properly considered and thought-through decisions they will make errors.

Although I have not been part of a buy-in or a buy-out, I have been involved in putting interest rate swaps in place. The idea was brought to the trustees and it was agreed that we should learn enough about it to enable us to decide if it was the right thing do. Accordingly, we set up an education programme and then decided we would do it. From here, we formed a group to manage the implementation and set up triggers for it. The whole process took about two and a half years from start to finish. We had to wait until the market met the triggers before executing the deals.

I hope everyone knows that the better your data is, the better the deals will be that the insurers offer. That is in part why there has been a move within the industry to clean up data and if you haven't been down this administrative journey of checking to see how good your data is, it could easily add a further year on to any process you eventually choose to make.

Chido: Indeed we have heard about some transactions where it's all been moving down the line but there comes a point where the data is not up to scratch and the insurer just stops the deal.

Philip: Part of the reason behind our decision to outsource the administration a couple of years ago was to enable us to maintain and increase the quality of the data.

As a £1 billion scheme that is closed to Defined Benefit (DB) accrual, we recognised that these types of deals will be on the horizon; therefore the quality of data has become very important. You need to have quality data to know whether you have reached the point where a buy-in or a buy-out would be beneficial or not, as well as to ensure that your actuarial assumptions about longevity are correct. It is amazing how bad data can get because people don't keep you informed as to what is happening in their lives.

Chido: There is a lot of discussion in the market place about these new styles of de-risking, mostly the medically underwritten annuities, but also longevity index trades. Is this the way the de-risking market is going?

Philip: This seems inevitable as markets develop. However, there has been a significant consolidation in the players in the insurance industry and the number of counterparties that are executing these transactions is reducing. Depending on what these larger conglomerates do, it seems that these organisations will be offering more niche products.

The trustees considering these niche products will decide whether or not they are right for them. With medically underwritten annuities, they almost certainly will be the right thing to do. In my experience in the Defined Contribution (DC) world, annuitisation has always been a big issue in terms of getting the best deals for people with open market options. The increased annuity that members can get by going down the medically underwritten route in a DC world is significant. In a DB world it should cost the trustee less, so if you can save money, why wouldn't you want to get involved in this?

Chido: I suppose some trustees may still be concerned about going down this route and later finding out that they have a super healthy population then they would have exposed themselves to the insurers.

Philip: Yes but this comes back to the point I made earlier that you should take decent advice from your advisors before you go down this route. As the market develops, the insurers will become sharper in their approach and they will recognise different industries and sectors so if there any issues, they will all come out in the wash.

Index trades might become more useful in some ways than straight longevity deals because you can buy and sell them - and remember, longevity isn't cast in stone, it is a set of assumptions. There is a suggestion that as our lifestyles change and we have increased obesity, etc. the idea of what is 'healthy' might change.

Chido: The pricing of the longevity swaps in the traditional sense was deemed to be too expensive for many of the smaller schemes and so these index trades are now being tipped to be the more affordable version that the smaller schemes are able to buy into.

Philip: Indeed, because the cost is spread out and you are just buying a product. So it could definitely be a useful idea for the smaller schemes.

There is bound to be increased closure of small schemes in comparison to larger schemes. This is because the larger schemes can afford to keep going longer, whereas the smaller schemes do not have that luxury and so there is a lot of pressure to wrap them up.

Chido: Thank you for taking the time to share your insights on this.

> "Independent trustee experience should bring some knowledge and help trustees identify what they need to learn."

SECTION 6

EUROPEAN SURVEY

FOREWORD

Introduction to the European survey

SURVEY RESULTS

Survey graphs

FOREWORD

Introduction to the European survey

Chido Tagarira
Senior Publisher, Clear Path Analysis

As Defined Benefit schemes continue down the path of extinction with closures to new entrants - and some even going a step further and closing to future accrual - scheme managers and their respective employers are increasingly turning to bulk annuity and longevity hedging transactions. As a result, the bulk annuity and longevity hedging market is experiencing record growth after a successful 2013 and 2014 expected to be an even bigger year for the market.

The inaugural survey, conducted by Clear Path Analysis for the Pension Buy-Outs & Longevity Hedging 2014 report, examines the views of 60 senior finance, pension and treasury professionals to better understand their perspectives on de-risking pension schemes in the current marketplace environment.

Of the respondents, 62% stated that they have a very high level of awareness regarding the impact that longevity risk has on their pension liabilities. This could arguably be one of the factors behind the rising interest in bulk annuity and longevity hedging transactions with 42% of respondents stating that they are considering a non-medically underwritten buy-out, a medically underwritten buy-out, a plan specific longevity hedge or a longevity index hedge. Moreover, it appears that they are looking to act quickly as 33% of respondents reported that they are considering, very likely to, or already in the process of, transferring risk to a third party insurer in 2014.

Furthermore, the results show that schemes are considering all the de-risking options available in the market with 33% of respondents stating that they were looking at Pension Increase Exchange (PIE), Enhanced Transfer Value exercises (ETV) or similar programs.

Amongst all those surveyed, the three biggest concerns reported were the low yield environment (25%), current funding status (23%), and the impact of regulations (18%). With 62% of survey respondents reporting that they are using a liability driven investing (LDI) strategy, it appears that the low yield environment and current funding states are the catalysts behind a shift in asset allocation strategies over the next 5 years, as 30% of all survey respondents stated that they will likely move towards alternative assets. Perhaps this is an indication that the alternatives are becoming cemented as the yield deliverers given the recent performance of traditional assets, and therefore, the search for yield is resulting in schemes altering their risk appetite.

However, with a large proportion of respondents (32%) stating that they are likely to move towards fixed income assets in the next 5 years, it could be argued that concerns around the impact of regulations are still a significant factor as to why the market appears to still be very much dominated by risk-averse scheme managers. In addition, the 55% of survey respondents that expect interest rates to increase slightly in the next 12 months may view a shift towards fixed income as being particularly timely. Notably, 43% of respondents stated that the movement of interest rates, be it an increase or decrease, would have no impact on their decision to utilise an LDI strategy or a bulk annuity transaction.

The plan-specific longevity hedge was the dominant de-risking strategy as 56% of the survey respondents stated that this is what they are considering to bridge the pension scheme funding gap. This is particularly interesting at a time when longevity hedging transactions, because of the cost of the transaction, are largely viewed to only be options for the larger schemes. However, with the increasing discussions in the de-risking market place about longevity index trades, which can allow the transfer of the longevity risk for deferred and active members, it seems there may be opportunities in the future for the smaller schemes to transfer their longevity risk in this format.

Overall, the survey reiterates a lot of the sentiments throughout the Pension Buy-Outs & Longevity Hedging 2014 report around the merits these de-risking tools for DB schemes. It remains very scheme dependent as to which tools will be more effective, if at all, but it appears that many scheme managers are currently considering, or are in the process of completing one of these transactions. Or, perhaps, schemes are just a bit more open and vocal about it now that bulk annuity and longevity hedging transactions are becoming more mainstream in the DB pensions market.

SURVEY RESULTS

1 Biggest pension scheme concerns

Current funding status
23%

Impact of regulations
18%

Employer covenant
17%

Longevity risk
17%

Low yield environment
25%

Poor data quality
0%

2 Expected shift in asset allocation strategies over the next 5 years (up to 2 options chosen)

Real assets
13%

Alternative assets
30%

Fixed income
32%

Mixed assets
25%

Equities
8%

Other
23%

With a growing number of UK and European based pension schemes reaching fully funded status, the shift towards fixed income (32%) can be attributed to the desire to crystallise the current scheme valuation.

The shift towards alternatives is also a notable result. However, it is not overly surprising as there has been an increasing amount of public commentary amongst European institutional investors that a shift towards alternatives would likely materialise in 2014.

Probably the most surprising result was that none of the respondents felt that poor data quality was a significant concern. With the likelihood that more longevity hedging transactions and pensioner buy-outs will take place, the importance placed on data would have been expected to be more prevalent than it really is. Arguably, this result tells us that the primary concern for schemes is securing the health of the pension scheme now over focussing on challenges down the road.

3 Percentage using a Liability Driven Investment (LDI) strategy?

Yes 62%

No 38%

Further analysis of the 38% who answered 'No':

Used in the past 0%

Planning to implement in 2014 5%

Would consider in the future 8%

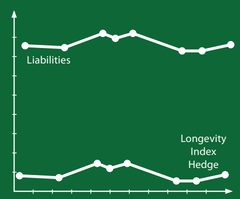
4 Options being considered to bridge the pension plan funding gap

NONE 58%

Of the 42% who were considering options to bridge the funding gaps:

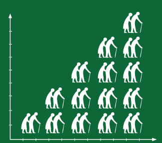
Medically underwritten buy-out

8%



Plan specific longevity hedge

56%



Longevity index hedge

24%

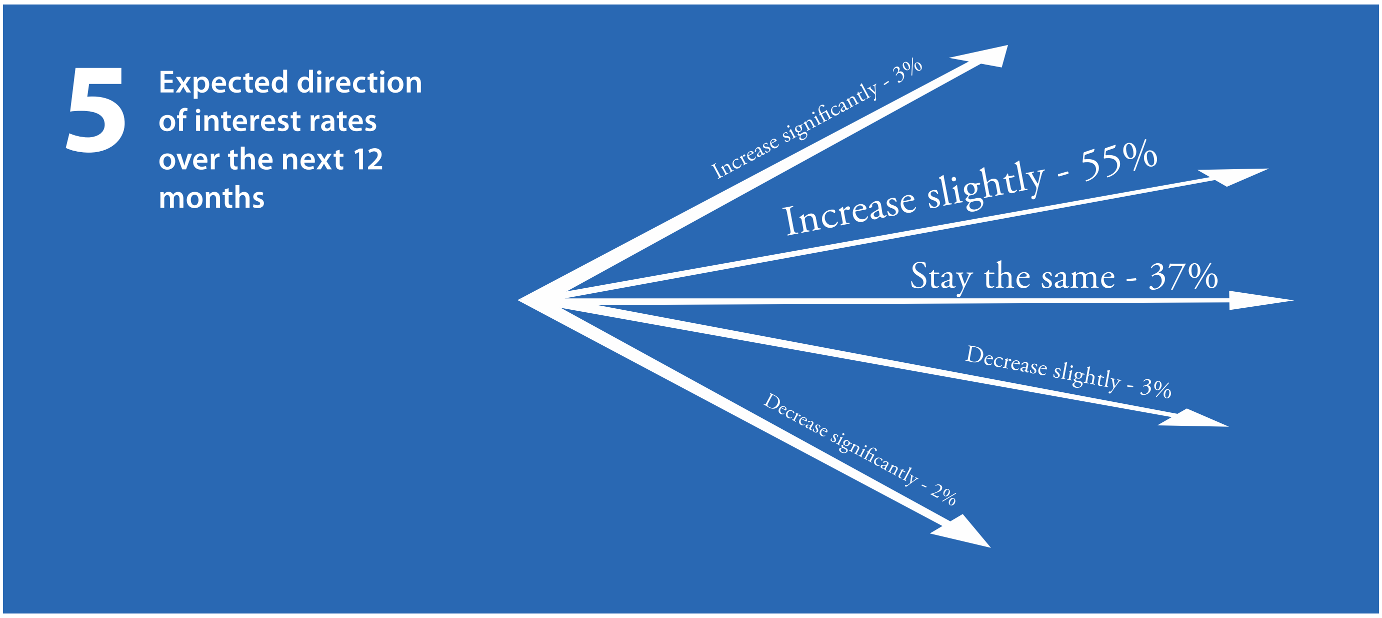
Non-medically underwritten buy-out

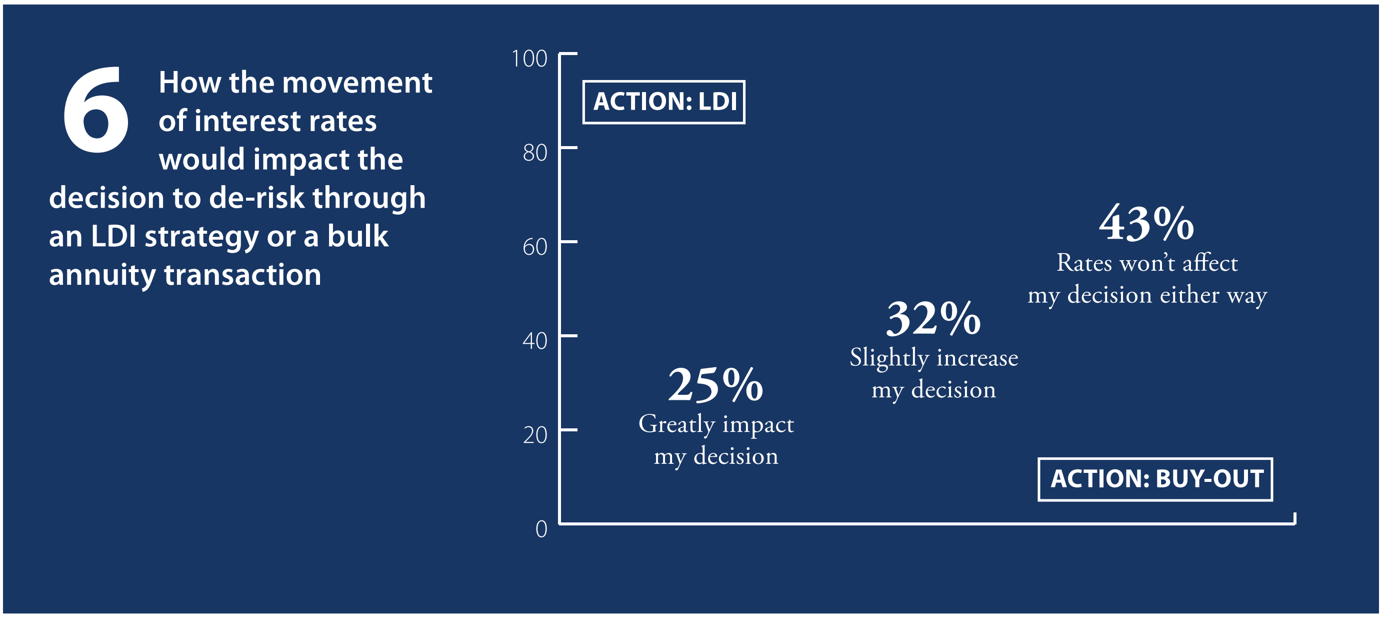
28%

Despite the Liability Driven Investing (LDI) industry's large size, the number of schemes that actively use LDI structures still has significant room for growth with just under 2 in 3 schemes utilising the structures. However, of the schemes that don't currently use an LDI strategy, just 13% are currently planning or would consider implementing it in the future, leaving a quarter of the total number of respondents asked not considering LDI structures at all.

In the area of risk transfer, the results have shown that longevity hedging transactions win out over traditional or medically underwritten buy-outs combined. Longevity index hedges are also gaining popularity as schemes looking to avoid the cost of extensively interrogating their data seek to hedge against a public benchmark.

SURVEY RESULTS



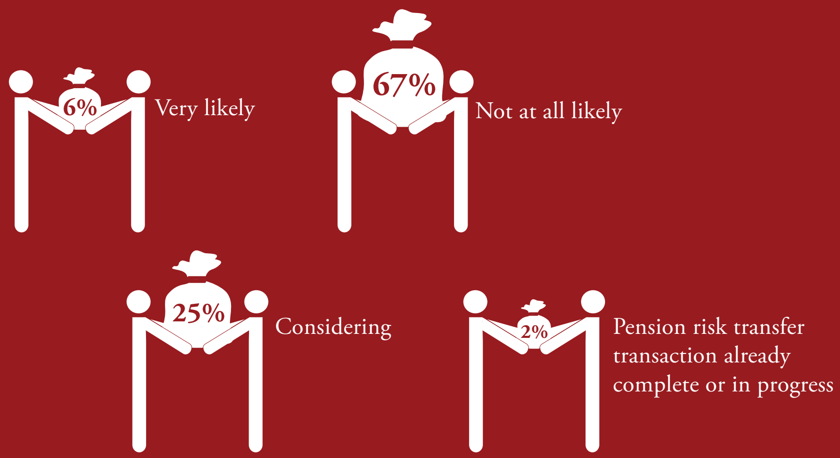


With forecasted inflation rates still at a relative low comparable to long term trends, the unanimous view is that if there were to be any change it would be gradual. This largely echoes Bank of England statements on when they would look to raise rates.

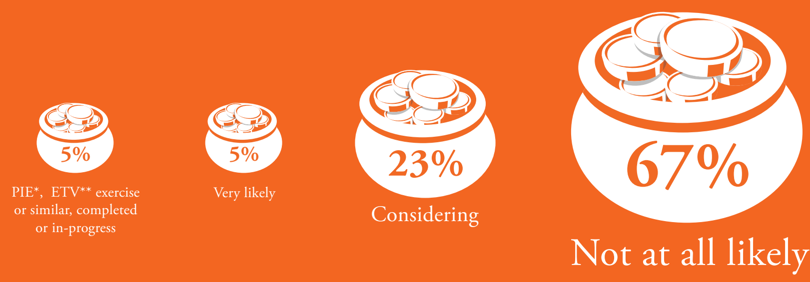
What is arguably more interesting however is the significant split in attitudes towards any interest rate movements. A quarter of respondents felt rate changes would significantly impact any decision to de-risk whilst not far from half believed it would have no effect whatsoever. The possible reason for such results occurring is that any implementation of an LDI strategy or risk transfer transaction would have been preceded by a significant amount of planning and testing of variables likely to affect the efficiency and success of employing such strategies.

SURVEY RESULTS

7 Likelihood of beginning the process of transferring risk to a third-party insurer in 2014



8 Likelihood of beginning the process of implementing a Pension Increase Exchange (PIE) or an Enhanced Transfer Value exercise (ETV) or similar program



**Pension Increase Exchange Enhanced Transfer Value exercise*
***Enhanced Transfer Value*

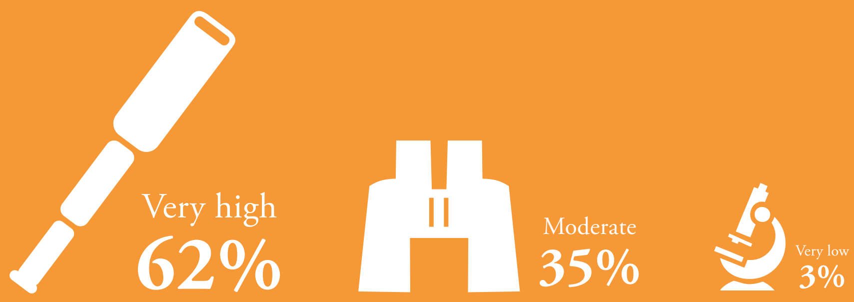
The most interesting finding of the entire survey is arguably that 1 in 3 schemes are considering or already in the process of transferring risk to a third party in 2014. Given that a large number of schemes reported a move into, or increase in, their fixed income exposure in 2014, the probability that an even greater amount of pension schemes will expect to transact in 2015 is reasonably likely.

Again, the same can be mirrored for PIEs and ETVs demonstrating schemes are exploring the range of options available to them before deciding what type, if any, risk transfer action they will undertake.

Following the announcement by the UK Treasury's Spring budget that pensioners will be able to withdraw some or all of their pension, annuity providers may now concentrate more of their efforts on securing bulk risk tranches meaning lower rates and more choice for prospective users.

SURVEY RESULTS

9 Level of own awareness of the impact of longevity risk on pension liabilities?



It is welcoming to see that 62% of respondents feel they are well aware of the impact of longevity risk. However, many may find longevity hedging transactions complex which in turn could hold back the market place unless adequately addressed by providers and advisors.

In summary, the 'Pension Buy-Outs & Longevity Hedging' survey has shown that pension scheme representatives are actively exploring their options for de-risking whilst staying open minded to the range of choices available to them. Many appear to have either already conducted data cleansing projects or potentially have not prepared their scheme for a risk transfer transaction, as the finding of zero participants being concerned by poor data quality demonstrated. As the European economy continues to strengthen, it will be interesting to note how sentiment towards off-setting pension liabilities changes.

This survey has demonstrated why access to relevant opinions of past users is so important to the development of the de-risking sector. Clear Path Analysis is very proud to have gathered the views of senior pension scheme representatives and we once again thank all who participated.

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