



MANAGING PENSION SCHEME RISK WITHIN THE BUYOUT MARKET

The big picture

Companies have a duty to manage any material pension liabilities as effectively as they can. Poor management of these liabilities can have a direct impact on the company's "bottom line" results.

In recent years, changes in regulations and accounting standards have meant that running a defined benefit arrangement has become significantly more onerous.

- Current funding regulations tip the balance of power in favour of the trustees when it comes to what contributions the employer should pay;
- Stricter accounting standards require pension costs to be reported in a realistic way consistent from year to year, with very little scope for smoothing;
- Since 2003, solvent companies have not been able to exit a pension scheme without funding the scheme to the full buyout level.

The bad news for employers is that the outlook is not likely to improve in the short to medium term. Further improvements in longevity, continuing market volatility and an increased emphasis on governance and regular disclosures are likely to make defined benefits provision more expensive than ever.

Managing the risks associated with a final salary scheme may therefore be one of the biggest challenges that a Finance Director has to face. Whilst it is true that the "nuclear" solution of full buyout may not be suitable for everybody, it is also true that the range of opportunities available on the market is sufficiently vast (and in many cases, inexpensive) to suit most circumstances - not investigating such opportunities may be very hard to justify.

A changing market

Traditionally, the only way defined benefit liabilities could be settled once and for all was through the purchase of deferred and immediate annuities from an insurance company (and until recently the market had shrunk so that you were likely facing the limited choice of either Prudential or Legal & General). Buying out the liabilities was normally done only as part of the wind up of a pension scheme, when the principal employer associated with the scheme had become insolvent.

Over the past few years, however, the appetite for de-risking pension schemes has steadily grown. At the same time a large number of new participants have entered the market giving a lot more choice to employers and trustees.

The new entrants can be broadly split in three categories:

- a) Traditional insurers who also have other lines of business;
- b) New companies set up for the purpose of providing buyout type products to an expanding market;
- c) Investment banks, trying to diversify their portfolio and take advantage of the commercial opportunities available.

A much larger market with many competitors does not just mean lower prices - it also means new products becoming available, as the various companies aim to differentiate themselves through their flexibility and the innovative solutions they are willing to offer.



The 5 key steps to a successful de-risking programme

Set out below are the principal steps and considerations for a de-risking exercise and the main issues we believe are crucial to a successful and efficient process.

Step 1 Consultation and advice	PCS will: <ul style="list-style-type: none"> Consider whether a 'plain vanilla' buyout is required or whether alternative solutions (such as a partial buyout or a longevity transfer) would suit your particular circumstances better; Assist you with identification of clear objectives, considering the circumstances of all stakeholders and any communication plan required (for example, from a company to the trustees or from the trustees to the members); Consider all financial implications and potential ramifications. Stress non financial objectives (such as a reliable administration service) which you should take into account; Clarify what level of involvement you wish to have throughout the process.
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What PCS can offer: A thorough understanding of the market (products and providers) from a unique 'inside' perspective.

Step 2 Preliminary broking work	PCS will: <ul style="list-style-type: none"> Investigate the quality of the data available, what is crucial to the exercise and what is required to allow the broking to proceed; Draft a complete, unambiguous benefit specification which will enable a quotation to be provided with a minimum number of queries; Set out a standardised, easily readable quote requirement document to ensure quotations will be carried out on a like for like basis; Identify which areas may require legal input and, if required, liaise with legal advisers to clarify any issues.
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What PCS can offer: This part of the exercise is essentially process led. PCS have developed robust processes to deal with the preliminary work as quickly and efficiently as possible.

In our experience, the importance of good quality data is often not appreciated in terms of the financial impact it can have on a buyout transaction. Depending on the type of buyout solution sought, high quality data can reduce the purchase price by as much as 10%. Together with our sister companies JLT and Profund, PCS have developed a process and methodology to deal with data due diligence analysis and cleansing. We believe this is an essential part of any successful buyout process.

Step 3 Broking & recommendation	PCS will: <ul style="list-style-type: none"> Identify timing requirements and best method for price negotiation; Appoint a formal project manager to ensure timescales are adhered to and resolve any issues that may arise; Set up method to share information (such as an external secure site) so that any further information or clarification can be provided in real time to all participants.
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What PCS can offer: PCS can offer whatever method of price negotiation is identified as best suiting your circumstances (including online auction if required). PCS's processes are set up to be compliant and will ensure a complete audit trail is available for your records.

Step 4 Asset transfer	PCS will: <ul style="list-style-type: none"> Consider whether investment advice is required in advance of the exercise being undertaken; Identify whether an in specie transfer is indicated and carry out as much preliminary work as possible while the broking exercise is ongoing.
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What PCS can offer: PCS can offer strong transition management capabilities and the ability to offer a detailed report following the exercise, to include a complete audit trail with full asset listing.

Step 5 Policy implementation (including provision of final data)	PCS will: <ul style="list-style-type: none"> Ensure this part of the exercise is carried out quickly as there may be adverse financial implications (such as PPF levies being payable) if matters are left unfinished; Different insurers do things differently and have different standards and so an understanding of each insurer's implementation process is very useful.
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What PCS can offer: Because of its detailed understanding of what is required, PCS are able offer effective project management of the exercise until final completion.

Why PCS?

PCS can demonstrate:

- extensive consulting experience in the fields of both de-risking and buying out liabilities;
- a thorough understanding of the buyout market, supplemented by the in-depth knowledge of the providers derived from being a part of the JLT Group;
- evidence of robust yet streamlined processes to assist clients with identifying and implementing potential solutions.

For more information on how we might help, please contact Aled Edwards on 0117 968 9628, Tiziana Perrella on 0161 242 5332 or Charles Cowling on 0161 242 5388.



Aled Edwards
0117 968 9628
aled_edwards@pensionstrategies.co.uk



Tiziana Perrella
0161 242 5332
tiziana_perrella@pensionstrategies.co.uk



Charles Cowling
0161 242 5388
charles_cowling@pensionstrategies.co.uk

Which buyout solution is right for me?

The solutions currently available on the market cover both ends of the spectrum in relation to the transfer of pension risk.

Partial solutions are available, where insurance within the buyout market is used as simply another asset class. Alternatively, total transfer of risk (for the whole scheme or just for a sub-group of members) can also be achieved.

Innovative deals have been struck where insurance companies have agreed to take on the risk deriving from incorrect data or unclear benefits in exchange for an additional risk premium payable at the outset. Other deals have seen the insurer even go a step further and effectively take over a scheme in full by replacing the scheme's principal employer.

Non traditional solutions include:

Phased buyouts - This is an arrangement where a bulk transfer policy is purchased as a investment of the scheme. At the same time terms are agreed to secure benefits for the remaining members over an extended period of time.

Longevity swaps - This is an investment for schemes wishing to hedge their mortality risk. Contracts are available on a scheme specific mortality basis or by reference to a general mortality index.

Specialist insurance policies - There are an increasing number of new products coming to the market, e.g. Tactica offer a policy, which guarantees that the scheme's funding level will not deteriorate on an agreed basis for an agreed period (such as ten years).

Pension Capital Strategies

The increase in the level of sophistication within the de-risking market has meant that consulting in the de-risking and buyout areas is now a specialist job.

Even in the context of a straightforward bulk buyout exercise, increased competitiveness means that specific skills are required to:

- achieve the best possible price available from the whole market;
- ensure that there is an auditable, compliant process in place to see the exercise through.

Companies must have complete trust that their advisers understand the current state of the market. Pension Capital Strategies (PCS) was set up in 2006 with the specific aim to assist companies with managing their pension liabilities in a changing market. All the individuals involved with PCS have extensive knowledge of the market and its offerings, gained via their consulting experience with major financial institutions.

PCS is fully owned by Jardine Lloyd Thompson (JLT). JLT is a major player in the buyout market, providing assistance and advice to no less than six of the major providers. This gives PCS a deep insight into the market, which distinguishes us from our competitors.

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