

DB pension plan de-risking

What is de-risking?

Over the past few years, defined benefit (DB) pension schemes have become an increasingly important issue for companies. A combination of tightened accounting regulations and dramatic market fluctuations have highlighted the risks inherent in many DB pension schemes. Pension de-risking helps corporate sponsors and trustees remove or reduce the risk of additional financial costs associated with running DB pension schemes.

The de-risking market - buy-ins, buy-outs and longevity hedging - is big business in the UK. The value of transactions expected to be completed in 2011 is around £13 billion. The total UK DB liability is over £1,000 billion, only about £45 billion of liabilities has been insured. Following the turbulence of 2009, trustees and employers of DB schemes will have a focused approach to managing benefits and liabilities, so we expect de-risking to be at the top of their agenda for the next decade.

Why de-risk the DB pension plan?

The cost to employers of operating a DB pension scheme are rising dramatically and will continue to rise in the years to come. We are now at the point where the cost of de-risking will almost certainly be less than the long-term cost of doing nothing.

This may be the moment to look seriously at removing or managing the risks in your pension scheme. The reasons are compelling:

- Volatility remains in the investment market - equity gains need to be locked into bonds and gilts
- Longevity (how long people will live for) has increased considerably - a pension scheme member living for one extra year than expected adds c3.5% to gross pension liability
- Investors and lenders favour companies where management are actively tackling 'the pension problem' £400 billion of FTSE 350 shareholder value at risk from un-hedged pension liabilities
- De-risking frees management to pursue rewarded risks and boost company enterprise value
- De-risking removes the risk of unexpected, additional funding requirements for the pension scheme

In short de-risking your scheme can provide you with cash flows into your scheme which exactly match the cash flow payments the scheme needs to make to its retired pensioners.

Profile for de-risking

Meeting any of the following criteria means that you are likely to benefit from de-risking your pension plan. For example following the triennial or an updated actuarial valuation, has your pension scheme funding position declined? Do you wish to remove risks from your scheme in a bid to increase the security of pension scheme members' benefits and to reduce the risk of extra contributions being made into the pension scheme? Do you have pensioners comprising 50% or more of total pension scheme membership? Do you have a pension scheme funding ratio of at least 50% on a scheme specific funding basis? Or is the sponsoring company considering any kind of restructuring? Pension scheme deficits are treated as corporate balance sheet debt by analysts, so de-risking a pension scheme that a deficit is a step towards de-leveraging the balance sheet.

Why should you de-risk now?

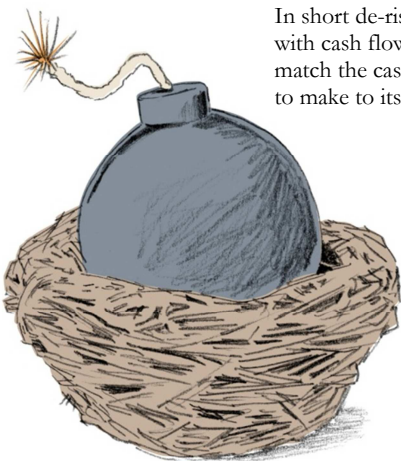
Most UK DB pension schemes have deficits that are at risk of increasing if no action is taken, but surprisingly the cost of de-risking the pension scheme is low when compared to the likely future cost of doing nothing. It is also seen by stakeholders as part of good corporate governance.

If you de-risk now, the gains that you might have made from the recent improved performance in the investment market can be locked in to reduce volatility. The cost of trying to de-risk might be significantly higher in the future for traditional insurance-based solutions, so the time to de-risk is now.

How do you de-risk?

We have identified a variety of de-risking solutions which may meet the requirements of your scheme.

- Liability driven investments (LDI): removes unrewarded interest rate and inflation risk by matching liabilities with assets
- Longevity swaps: protection against demographic longevity risk and allows employers to reduce pension scheme volatility - can be funded or unfunded; customised or index based
- Pension annuity buy-ins: insurance policies regarded as an investment asset of the pension scheme - it addresses all risks (longevity, investment, interest rate and inflation) except administration for a specified group of Scheme members (usually pensioners in payment)
- Pension annuity buy-outs: removes all pension risks by transferring accrued pension liabilities to a regulated insurance company in return for a premium
- Deferred premium pension annuity de-risking: Immediately or gradually removes all pension risks by transferring accrued pension liabilities to a regulated insurance company in return for a premium payment that is structured to reflect the client's funding ability



How can our de-risking services support you?

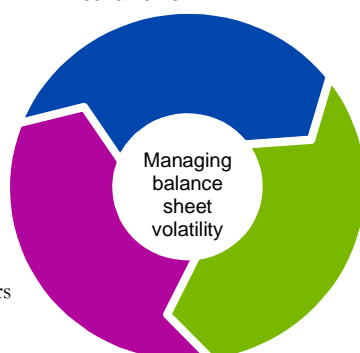
Our primary role is to provide independent advice on structured solutions and transactions which will either transfer out or mitigate your scheme risks. Our work can help both privately-owned and listed corporate sponsors, and their trustees, to reduce the sponsor's financial risk from the scheme, whilst at the same time better protecting the scheme members' benefits.

We also play an important role in providing pension advice in corporate M&A transactions.

We place managing the volatility of your balance sheet at the centre of our advice. We surround it with a thorough evaluation of the risk your scheme faces, a complete menu of potential de-risking solutions and providers, and a specialist pension advice in corporate M&A transactions where appropriate.

Pension risk quantification

- Size of scheme deficit
- Accounting liabilities
- Technical Provisions
- Insolvency liabilities
- Quantum and structure of scheme risk



Pension de-risking services

- Identify de-risking solution providers
- Obtain de-risking quotations
- Strategic de-risking advice for bulk purchase annuities (BPA)
- Longevity swaps
- LDI strategies
- Project manage de-risking implementation

Transaction advice

- Scheme provisions relevant to corporate activity
- Pensions regulation
- Notifiable event reporting requirements
- Clearance guidance
- Impact on covenant related to corporate activity

Does share price increase after de-risking?

Company	Date	Type of de-risking	Transaction size	Share price		
				before	after	% change
Babcock	May 2009	Longevity swap	£1.9bn	412	480	16.5%
Dairy Crest	June 2009	BPA	£310m	280	325	16.0%
Royal Sun Alliance	July 2009	Longevity swap	£1.2bn	113	130	15.0%
British Airways	July 2010	BPA	£1.3bn	188	207	10.0%
Denso	September 2009	BPA	£140m	1,900	2,020	6.0%
BMW	February 2010	Longevity swap	£3.0bn	2,870	3,040	6.0%
Cadbury	December 2009	BPA	£500m	791	837	6.0%

10.2% Average



Comment

“In June 2008, with pension liabilities three times higher than its market value, Delta agreed to transfer £400 million of the pension scheme's total £640 million assets to buyout specialist Pension Insurance Corporation. The shares rose 8p to 135p on the news, despite the £50 million cost... Any step taken to deal with a company's pension situation usually pushes up the shares.”

Cheryl Jones
Moneywise.co.uk
29 Sept 2009

“The markets, and shareholders, want to see evidence that management have got pension risk under control, with a clear plan of action to sort out the problem.”

David Collinson
FTAdviser.com
5 Jul 2010



Comment

“The pension deal underlined strong results for the year to March, with Babcock's pre-tax profit surging 27pc to £120.9 million and revenue climbing 22pc to £1.9 billion. The engineer also reported a 90pc increase in its order book for next year and raised its dividend, payable on 7 August, by 25pc to 14.4p. The shares closed up 68 at 480p.”

Babcock longevity swap deal announcement
Daily Telegraph
12 May 2009

Case studies

Project A	Key issues	De-risking strategy and the effects
<p>A leading player in the automotive sector with a turnover of £40 million but with a deficit of £20 million and liabilities of £100 million</p>	<ul style="list-style-type: none"> • Owners want to sell operating business and exit within three years • DB pension deficit could undervalue the selling price of the business • Proposed level of contributions is unattractive to new investors 	<ul style="list-style-type: none"> • Partial de-risking through a pension annuity buy-in • Strategy implemented with a well-capitalised, specialist UK insurer • £30 million worth of liabilities were de-risked with £32 million of pension fund assets transferred to the insurer (the insurer valued the liabilities at £32 million) • The company paid an extra £3 million into the pension fund to cover the £2 million insurance cost and improve the funding ratio • The company's share price rose by 15% from £0.28 to £0.32 post-completion of the de-risking deal • Market capitalization increased from £60 million to £69 million • Investment, longevity, inflation and interest rate risks were all hedged for all the fund's retired pensioners • The funding ratio improved from 80% to 83% • Going forward, a higher discount rate was used to value the pension liabilities, given the perceived lower risk in the scheme • Annual contributions came down from £1.5 million per year to £1 million over a longer time period (10 years instead of five)
Project B	Key issues	De-risking strategy and the effects
<p>A company in the Rail sector with a target turnover of £360 million and an IAS19 pension scheme deficit of £132 million and FRS liabilities of £233 million</p>	<ul style="list-style-type: none"> • Privately owned Group proposed cash offer for Target • Target had substantial DB Pension Scheme • Understand Scheme risks/mitigation and implementation costs • Determine enterprise value 	<ul style="list-style-type: none"> • Identified which risks the pension obligations were most sensitive to • Projected the future costs of funding the pension scheme as a result of risk crystallisation c£12.5 million • Recommended solutions for mitigating the most pertinent pension scheme risks post transaction completion • Showed that mitigating the pension scheme risks saved our client c£4.75 million • Estimated potential positive impact on share price following pension scheme de-risking • Advised on provisions of Target's Scheme relevant to takeover • Solutions included bulk purchase annuities, longevity swaps and liability driven investment (LDI) strategies

Key contacts



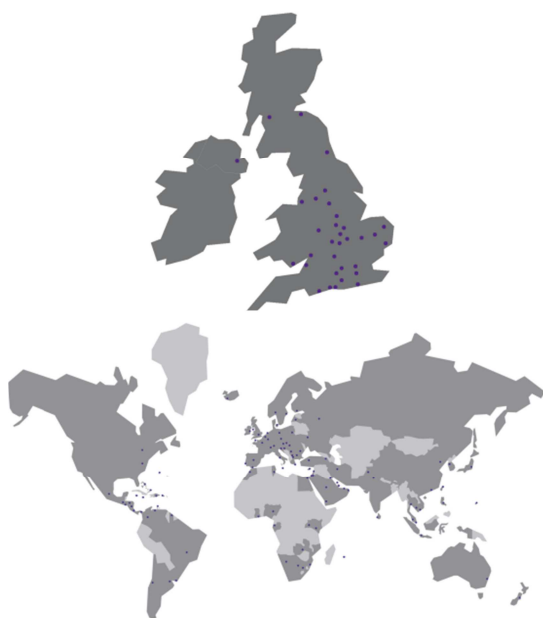
Darren Mason
Partner
T +44 (0) 20 7728 2433
M +44 (0) 7971 434 964
E darren.m.mason@uk.gt.com



Kelvin Wilson
Associate Director
T +44 (0) 20 7865 2402
M +44 (0) 7879 667 208
E kelvin.wilson@uk.gt.com



Russell Clarke
Associate Director
T +44 (0) 20 7865 2484
M +44 (0) 7795 616 906
E russell.clarke@uk.gt.com



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