

# De-risking market quarterly update: Q2 2011

## Introduction and summary

Welcome to our quarterly update on the latest developments in the defined benefit (DB) pension plan de-risking market. We will be looking at all aspects of the market, including regulatory developments, product development, completed transactions, product pricing and market sentiments. We will also provide views on the future development and shape of the market

This continues to be an extremely interesting and dynamic time in the de-risking market, with activity increasing as the UK economy slowly recovers in the aftermath of the global recession

In this update, we look at the months April to June 2011, providing a background to some pertinent regulatory issues, the drivers behind recent de-risking activities, some innovative de-risking solutions that we can advise on and a preview of how we think the market will develop in the next six to twelve months

## Regulatory issues in the market

### The switch from RPI to CPI indexation

The UK government has confirmed that it will not introduce legislation to force pension schemes that have revaluation linked to RPI to switch to CPI. This means that trustees will not need to change scheme rules which specifically refer to a revaluation and increase rates linked to RPI

Insurance companies have already started to take into account the assumption of CPI in some of their buy-in and buy-out quotations

### Solvency 2

The implications of Solvency 2 on insurance company reserving continue to be debated. The most likely result is higher capital requirements for bulk annuity writers

Most insurers have indicated that their current pricing of buy-ins and buy-outs reflects their expectations of Solvency 2 reserving requirements

### Guaranteed Minimum Pension (GMP) equalisation

As yet, there is no specific guidance on equalisation methodology. It is important that plans looking to buy in or buy out make an allowance for equalisation in their valuation of benefits, which they should then communicate to insurers. Some insurers are offering de-risking quotations that immunise the pension plan against inappropriate GMP equalisation methodology

### Appetite for de-risking

The global financial crisis of 2009 and early 2010 magnified the risks inherent within defined benefit pension plans. This has led to a sharp rise in the appetite of UK trustees and sponsors to de-risk their pension plans

Good corporate and pension governance is often associated with having a clear and identifiable strategy for managing or de-risking the pension plan. A wealth of new and innovative de-risking solutions have come on to the market. These solutions look to address the underfunded nature of many plans by minimising requirements for large asset transfers. Solutions include longevity swaps, deferred premium buyouts and asset swap structures

De-risking can be done in phases and the cost can therefore be spread over time. For example, deferred premium buyouts can be structured to fit in with an employer's schedule of contributions into the pension plan

## De-risking benefits for trustees and members

**Protect members' benefits** - de-risking the pension fund is seen as part and parcel of protecting and securing members' benefits

**Negotiating tool** - de-risking can be a condition for trustees to grant an employer a longer recovery period to pay off a deficit

**Better informed** - trustees have a better understanding of the range of de-risking options, together with their associated values

## De-risking benefits for employers

**Removing volatility** - sponsoring employers are keen to cap or remove the cost of operating the pension plan

**Business restructuring** - de-risking is part of a longer-term strategy to restructure the sponsoring employer through a sale or merger

**Enterprise value protection** - sponsors wish to invest in growing the operating business and do not want the enterprise value of the business to be artificially depressed by the pension fund

## Market news

Business undertaken during Q2 was low, but we expect increased quotation volumes and further transactions in Q3 and Q4, as investment markets and buy-out prices improve due to increased competition and insurers' assumptions using CPI revaluation

In an attempt to make deals more affordable, particularly to underfunded schemes, insurers are offering a variety of payment options to trustees and employers. There are three main types of contracts:

- Partly deferred payments, where the outstanding funds, on top of the insured members' share of funds, are paid over a prolonged period
- Deferred insurance, when a scheme keeps the liabilities to be insured for a certain amount of time to amortise



- the difference between the full premium and the amount that is affordable at that given moment in time
- Tranched solutions, when the liabilities are offset in tranches over an agreed period of time on partly guaranteed terms, an example would be the deal between London Stock Exchange and Pension Insurance Corporation

The most popular contracts are still pensioner buy-ins. This is due to pensioners being viewed as more 'affordable' than non-retired active and deferred members. In addition, limited funding levels mean that buy-ins can be completed more quickly than buy-outs since there is less of a necessity for immediate funds

Strategy	Indicative price (excluding adviser fees)
BPA* buy-out	40% to 60% above accounting liabilities
BPA buy-in	10% to 20% above accounting liabilities
Indemnity-based longevity swap	10% to 15% above actuarial Technical Provisions (using medium cohort with no underpin)
Index-based longevity swap	5% to 10% above actuarial Technical Provisions (using medium cohort with no underpin)
Deferred premium BPA	Initial price will be in line with BPA buy-out or buy-in pricing, but total premium payment (including lower initial premium) is likely to be higher than initial price due to longevity guarantee and/or interest on deferred premiums

\* Bulk Purchase Annuity

### Market sentiment

Investors and equity analysts are increasingly taking into account the risk management strategies of companies with DB pension funds. There is evidence to suggest that the market responds positively to companies that have implemented a materially significant risk reduction strategy on their pension plan

### Quotations and stakeholder management

Providers report that quotation requests are up from this time last year, with a 60/40 split between BPA and longevity swap quotes respectively, against a 50/50 split in 2010. Amongst our clients, there is a split of 80/20 between BPA and longevity swap de-risking enquiries. We are finding that there is increasing interest from clients about longevity hedging on an indexed basis. Buy-ins continue to be the most popular solution considered by clients

If you are a stakeholder considering de-risking the pension fund, it might be useful to consider the following:

- Involve key stakeholders from the outset - a Joint Working Party or Committee - is key to ensuring that the process runs smoothly

- Resolve potential issues upfront – anticipate potential issues that might create a delay or increase the cost of the potential de-risking solution, such as guaranteed minimum pension equalisation
- Provide accurate data – whether you are undertaking a buy-in or any form of longevity swap, good quality data will be beneficial in terms of potentially lowering the cost of the de-risking solution
- Document benefits concisely – this will help to save time and ensure that the right levels of benefits are provided and secured
- Assess investment strategy – whether you are undertaking a buy-in or a longevity swap, it is important that the pension fund has the appropriate assets to transfer to an insurer or to use as collateral in any swap arrangement

### Outlook for the next 12 months

Pension de-risking continues to be at the top of most schemes' agendas. If the eventual end game is a buy-out, employers and trustees need to understand the market and prepare in advance. As part of that preparation, we recommend that an initial quotation is sought, investment strategy and asset allocation are adjusted if necessary and the required governance infrastructure is set up. This may even include appointing an independent trustee to supply any missing expertise

The number of contract structures available is growing so trustees and sponsors alike need to be aware of developments in the market and understand the implications for their schemes. As the economy improves and markets become more stable, we expect excellent opportunities to emerge in the market, followed by an increase in demand for solutions

The full impact of Solvency II requirements is still uncertain, despite many insurers claiming adjustments have now been made in their reserving basis to take full account of any adverse impacts, thereby implying the changes are already assumed in their pricing. A further point of concern is the persistent crisis in the Eurozone. Any default could have a heavy impact on the UK and European economies, as well as having a detrimental impact on the funding position of many UK schemes

The outlook for the rest of 2011 seems positive with capacity set to increase as new players enter the market. There is a strong desire for insurers to innovate, due to trustees and sponsors wishing to reduce their risk or even liquidate their defined pension scheme, if at all possible

### Bulk purchase annuities

A combination of improvements in the investment market and stronger funding requirements will see a narrowing of the gap between buy-out and on-going funding costs. In some instances, a pensioner buy-in could lead to an improvement in the scheme's funding position

We expect there to be more innovation around the products offered and that market capacity will rise as new players enter the market. This will in turn lead to competitive pricing and real opportunities for plans to de-risk. Our forecast is that the total BPA transaction value will reach nearly £5 billion by year end 2011.

**Longevity swap market**

No longevity transactions were completed in Q2. Some negotiations may be continuing on a number of very large schemes, including some which may be investigating a more conventional bulk annuity product

Based on a change in JPMorgan's LifeMetrics mortality index, the first longevity hedge deal was completed by the Pall (UK) Pension Fund. The contract has a term of 10 years and provides a reliable way to soften the mortality risk for non-pensioners. It hedges against changes in the overall population rather than going by the experience in the

scheme. This is a useful de-risking tool for schemes to incorporate, since a major factor of the risk is dependent on medical developments and other national trends

The first indexed longevity deal for non-pensioners is an area of interest, since it has great future potential. Having said that, it is unlikely to draw much attention to the vast majority of schemes. No longevity swaps have been reported since Q2 of 2010, despite their popularity throughout 2009 and early 2010. This is not a complete surprise since these deals are limited normally to large schemes, however we do still expect a handful of large transactions

**De-risking transactions in the past two years in order of size**

Date	Pension scheme	Counterparty	Value
July 2010	BA	Rothsay Life (Goldman Sachs)	£1,300m
November 2010	GlaxoSmithKline (GSK)	Prudential	£900m
August 2010	Alliance Unichem (Boots)	Pension Corporation (PIC)	£310m
May 2010	Unknown	Legal & General	£230m
March 2010	Aggregate Industries	Pension Corporation (PIC)	£210m
Q4 2010	Unknown Aviva deal	Aviva	£190m
August 2010	Next	Unknown	£124m
May 2010	MNOPF (2 <sup>nd</sup> tranche)	Lucida	£100m
Others	Others	Others	£110m
<b>Total</b>			<b>£3,619m</b>

## Notes:

- BPA pensioner buy-ins continue to be the most popular de-risking solution

**The major longevity swap deals struck over the past two years in order of size**

Date	Pension scheme	Counterparty	Structure: (indemnity or index-based)	Value
February 2010	BMW UK	Abbey Life (Deutsche Bank)	Indemnity	£3,000m
December 2009	Royal County of Berkshire	Swiss Re	Indemnity	£750m
February 2011	Pall (UK) Pension Fund	JP Morgan	Index	£70m
<b>Total</b>				<b>£3,820m</b>

## Notes:

- The first index-based longevity swap hedge for non-retired members was written in Q1 2011
- The deal between Pall (UK) Pension Fund was written for 10 years and it hedges the change in value of Pall's liabilities as a result of changes in longevity on active and deferred members, referenced to mortality changes in England and Wales
- Despite plenty of interest from clients, no indemnity-based longevity swap has been written since February 2010
- Longevity swap transactions take some time to execute and we expect at least a couple of transactions to be completed before year end 2011

### Our innovative solutions

While a pension annuity buy-in remains the most popular insurance-based solution used to de-risk a defined benefit pension fund, Grant Thornton can advise on a wide range of new and creative de-risking solutions, which are tailored to the size, risks and requirements of an individual pension scheme.

A buy-in, while a good solution for dealing with nearly all risks associated with retired pension fund members, is not usually cost-effective for managing the risks associated with non-retired deferred and active members. An indemnity-based longevity swap, while protecting the specific longevity experience of a pension fund, does so only on a portion of the fund (usually the pensioners in payment). To hedge the longevity risk associated with active and deferred members, an index-based longevity swap is increasingly seen as the most practical solution.

A 'DIY buy-in' is now a commonly-used term describing how pension funds can replicate the risk-mitigating features of a pensioner buy-in, through combining a pensioner longevity swap with an LDI matching strategy. The features of a buy-out can be replicated, by combining a pensioner buy-in and an index-based longevity swap on deferred member liabilities with an LDI strategy. While the solution does not allow a wind-up of the scheme, it can still be regarded as a 'DIY buy-out'.

We offer independent advice on structured solutions and transactions that will either transfer out or mitigate the risks in your scheme. Our work can help both privately-owned and listed corporate sponsors and trustees reduce the risk of financial losses as a result of the pension scheme and give more protection for members' accrued benefits. We also play an important role in providing pensions advice in corporate Mergers & Acquisitions transactions. We advise on deferred and phased buy-out solutions, which de-risk the pension scheme in a manner that is in line with the cash flow and budget requirements of the scheme and employer.

### Key contacts

If you would like to discuss how these changes may impact on you, please contact any of our specialists below:



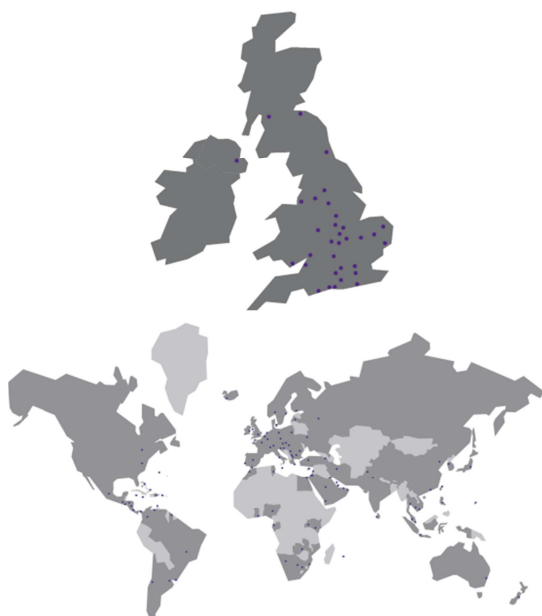
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