Original Article

De-risking and the flightpath to buyout

Received (in revised form): 4th January 2011

Emma Watkins

is responsible for new business development within the bulk annuity market for MetLife Assurance Limited. Watkins has over 13 years of experience in the pensions arena, holding positions with ACE Europe, Hazell Carr Pensions Consulting and Prudential, where she had product management, operational and client management responsibilities for multi-disciplined defined benefit and pension technical areas.

ABSTRACT Trustees and employers are increasingly looking at the various de-risking options available to help manage the £1 trillion liabilities in UK defined benefit pension schemes. This article investigates why there is an increasing appetite for de-risking, including the challenges faced by schemes as a result of increasing costs, longevity trends and accounting practices. De-risking exercises can take many different forms and can be tailored to an individual scheme's de-risking goals, trustee and company budgets, and relevant economic conditions. A number of options available to schemes are highlighted in this article and the concept of 'flightpath' (a designated plan that enables a scheme to reach buyout over a period of time) is explored. The ultimate end goal of securing pension scheme benefits for the lifetime of members and their beneficiaries is in the interest of all stakeholders involved. Through good communication and planning, the relevant steps can be taken to reduce risk in a pension scheme, while understanding that any plan needs to be adaptable as inevitably situations will arise that require manual intervention or a change in direction.

Pensions (2011) **16**, 69–74. doi:10.1057/pm.2011.2

Keywords: defined benefit; pension de-risking; longevity insurance; longevity swap; buy-in; buyout

BACKGROUND

The UK private pension system is undergoing profound change with a number of market developments leading to an increasing appetite for de-risking among defined benefit (DB) pension schemes:

1. *A continued acceleration in the trend for schemes to close to new members and future accrual:* The Pensions Regulator's 2010 report¹ on DB pension schemes showed that as at March 2010 only 18 per cent of DB and hybrid schemes were open to new members and future accrual, while 58 per cent were closed to new members and 5 per cent were closed to future accrual.

Fewer schemes closed to new members in 2009. However, a higher proportion of schemes already closed to new members then went on to close to future accrual (65 per cent compared with 50 per cent in 2008). As a consequence, of the 12.0 million members in DB and DB sections of hybrid schemes, 5.2 million (43.7 per cent) were deferred, 4.3 million (36.2 per cent) were pensioners and only 2.4 million (20.1 per cent) were active members. As the proportion of members in a DB pension scheme become increasingly distant to the employer, it is likely that the employer's commitment to the ongoing running of the DB scheme will reduce and thus accelerate the trend to close schemes in favour of defined contribution (DC). Supporting this, research conducted by PricewaterhouseCoopers² of 179 major

Correspondence: Emma Watkins
MetLife Assurance Limited, 15 Bedford Street, London, WC2E 9H, UK
E-mail: ewatkins1@metlife.com

Figure 1: Life expectancy at birth, United Kingdom, from period life tables, 1980–1982 and 2007–2009 – ONS

employers indicated that only 6 per cent expected to retain DB schemes in their current form. Despite this shift to DC, an estimated £1 trillion³ of liabilities still need to be managed.

2. *An increase in longevity trends:* Longevity risk – the risk that scheme members will live materially longer than is assumed – is one of the most topical and challenging risks being faced by pension schemes at the moment. Figures from the Office of National Statistics (ONS)⁴ show that life expectancy at birth in the United Kingdom has reached its highest level on record for both boys and girls. A newborn baby boy could expect to live 77.7 years and a newborn baby girl 81.9 years if mortality rates remain the same as they were in 2007–2009 (see Figure 1). Taking into account the continued improvement in mortality assumed in the 2008-based principal population projections, life expectancy at birth for those born in 2009 is projected to be 88.7 years for males and 92.3 years for females. However, part of the problem is that no one really knows how long people will live and whether the trend for increasing longevity will continue. Although further improvements in longevity are expected, the extent to which mortality rates will continue to fall and which age groups will experience the most significant changes are uncertain. One possibility is that longevity will continue to improve indefinitely through medical advances, improved nutrition and a better lifestyle. Conversely, pandemics, war

and adverse lifestyle choice may limit longevity improvements. However, the impact on pension schemes is clear – increasing longevity will cost employers more. A survey conducted by Mercer⁵ showed that member life expectancy assumptions increased by around 6 months in 2009, leading to increases in scheme liabilities of approximately 1.5 per cent.

3. *Changes in accounting regulations:* The Financial Reporting Standard 17 (FRS17) and the International Accounting Standard 19 (IAS19) require companies to declare the extent of their pension scheme assets and liabilities in their company accounts. Where a scheme is in deficit this is declared on the balance sheet, potentially reducing a company's profits and restricting its ability to pay dividends. In stable market conditions, the future effect of the pension scheme on the company accounts is relatively small. However, during financially volatile times, a company's reported results could be seriously affected by its DB scheme. This development has contributed to the move from DB to DC, but for those with ongoing DB liabilities to manage, de-risking a DB scheme can help reduce this volatility.
4. *Increased awareness of risk to members owing to insolvency and underfunding:* The Pensions Regulator's 2010 report highlights that the recession resulted in a large rise in the total level of corporate liquidations in England and Wales, from 3241 in Q1:2008 to a peak of 5041 in Q2:2009, an increase of 56 per cent. Since Q2:2009, economic recovery has resulted in a 19 per cent drop in the level of company liquidations. The estimated number of schemes (or sections of schemes) entering a Pension Protection Fund (PPF) assessment period peaked in Q1:2009 at 52 and fell to 38 a year later (by Q1:2010), a drop of 27 per cent. The level of schemes entering PPF assessment in the year to Q1:2010 was, however, still around 20 per cent higher than in the 2 years before the recession. These statistics demonstrate how important it is to monitor a scheme's sponsoring employer covenant – defined as 'an objective assessment of the employer's financial position and prospects as well as his willingness to continue to fund

the scheme's benefits'.⁶ Trustees will want to seriously consider de-risking to protect their members where it is reasonable to consider that the covenant may weaken.

As scheme sponsors, in partnership with their scheme trustees, determine whether to retain long-term DB liabilities on their balance sheets, the need to effectively assess and manage pension scheme risk is acute. De-risking can take many different forms, but the ultimate objective for many schemes is a full buyout where an insurance company takes on all of the assets and liabilities of the scheme, removing all future risk from the sponsoring employer. To fulfil that goal, a scheme has to be fully funded or the employer willing to fund the difference. Although a fully funded position might not currently exist, building a 'flightpath' that enables the scheme to reach that goal over a period of time is an accessible aim.

BUILDING THE FLIGHTPATH

Stakeholder engagement

One of the greatest challenges in any de-risking exercise is ensuring agreement between the potentially large number of stakeholders involved. The trustees are usually the key stakeholders in the de-risking process. However, de-risking typically has financial implications for the employer, and thus their support is also very important. External third parties providing services such as administration, actuarial and investment, will also likely be involved in any de-risking activities, and therefore it is important to involve them at the outset.

One method of achieving consensus efficiently is to establish a subcommittee, which includes representation from all these stakeholder groups. It is advisable to put in place a delegated structure that avoids the need to consult the full trustee board at every stage. To achieve this, there should be a clear allocation of responsibility for the key decisions that need to be made.

Understanding your scheme

Once the appropriate governance structure has been implemented with the explicit task of

investigating de-risking options, one of the first tasks will be to understand all of the various risks faced by their individual scheme so that appropriate actions can be taken to tackle these issues from the outset.

Additional factors that will need to be considered are the risk management, financial and business objectives of the trustees and the employer, funding levels of the scheme and any additional budget available.

To get an accurate view of the scheme's funding position, the trustees should review the assumptions used in the valuation of the scheme's liabilities, particularly if the mortality assumptions have not been reviewed for some time. An exercise to establish the existing employer covenant should also be conducted, focusing on whether the employer is financially able to support the scheme and also whether it has an ongoing desire to retain the scheme. Companies that are financially capable may not want to retain the scheme. Even the most paternalistic company can find themselves in a position where due to changing circumstances (financial or managerial) the willingness or ability to support the ongoing scheme can vanish when it is most needed.

Determining your objectives

There are a range of tools that can be tailored to de-risking goals, budgets and economic conditions – Table 1 outlines considerations of a range of de-risking strategies that can be utilised.

In preparation for a thorough review to be carried out, the subcommittee may need to be trained on the available options, so that they have the appropriate knowledge and skills to agree and implement them.

PREPARING FOR TAKE-OFF

The importance of data

As trustees are well aware that good data is crucial throughout the lifetime of a pension scheme. This has been recently highlighted by the Pensions Regulator's Regulatory Guidance issued on Record-keeping⁷ in June 2010, which highlights that poor record-keeping can lead to

Table 1: Examples of de-risking options available to DB pension schemes

<i>Solution</i>	<i>Focus</i>	<i>Risk reduction/considerations</i>
Enhanced transfer values	Deferred members	<i>Risk transferred to members:</i> Members are offered a cash sum or increased transfer value to transfer benefits out of the scheme. Liabilities are transferred out of the scheme, but the individual is exposed to interest rate, inflation, investment and mortality risk. Please note: Pension Regulator Guidance, www.thepensionsregulator.gov.uk/press/pn10-25.aspx
Pension increase exchanges	Pensioners	<i>Risk transferred to members:</i> Members are offered a cash sum, or flat pension is increased in return for giving up non-regulated future increases. Liabilities are transferred out of the scheme, but the individual is exposed to the risk of inflation increases
Longevity insurance/swaps	Typically only available for pensioners	<i>Risk retained on company balance sheet:</i> Removal of longevity risk through an insurance policy/swap where the trustees will receive (or pay) the difference between the pension payments expected and the actual pension payments due. Asset risks and inflation risks are retained by the scheme. Likely to require significant trustee and management time for ongoing monitoring
DIY buy-in	Typically pensioners	<i>Risk retained on company balance sheet:</i> Removal of longevity risk through an insurance policy/swap coupled with a Liability-Driven Investment strategy that mitigates, but does not remove, interest rate and inflation risk. Potential exposure to reinvestment risk. Likely to require significant trustee and management time for ongoing monitoring
Buy-in	Typically pensioners	<i>Risk transferred to an insurance company:</i> Benefits with reference to selected members secured through an insurance policy assigned to the trustees. Removal of employer covenant, interest rate, inflation, investment and mortality risk for the secured benefits. May not require additional funding. Reporting processes need to be established for ongoing accounting and administration
Buyout	All members	<i>Risk transferred to an insurance company:</i> Members' benefits are secured through an insurance policy assigned to the individuals. Removal of employer covenant, interest rate, inflation, investment and mortality risk in full. Likely to require additional funding and management time needed for implementation

significant additional costs in a number of areas including administration, inaccurate actuarial valuations, and even claims from disgruntled members. For many schemes, the full extent of poor record-keeping is only realised after a major event in the scheme's life cycle (for example, when a scheme de-risks, a wind-up is triggered or the scheme enters the PPF assessment period). However, data cleansing at that point is often too late.

In preparation of de-risking, trustees should carry out a thorough audit of scheme data to ensure member records are accurate and up-to-date. Where issues exist, data cleansing should be considered before approaching the members where the exercise is a member option (for example, an enhanced transfer value or pension increase exchange exercise) or the market for

quotations (for example, for a longevity swap or buy-in/buyout).

In a member option exercise, bad data could lead to inaccurate benefits being offered to the member or the members not being contactable if addresses are incorrect or missing. In a quote process, inaccurate data can increase the time it takes for trustees to receive quotations from insurers. It can also affect the ability of an insurer to issue a formal quotation if, for example, some data items such as postcodes are incomplete. Moreover, if lack of data requires insurers to make assumptions on data benefits, which may differ across providers, comparing quotations can be a near impossible task. An insurer may also add a risk premium to the quotation to account for the additional costs poor data could lead to, with the size of the premium

being directly correlated to the size of the suspected data issue.

Finally, the costs of exercises looking specifically to de-risking longevity (either singularly or in conjunction with other risks) are typically based on a number of actuarial assumptions. If the scheme's experience can be shown to be more favourable than the assumptions being adopted, the de-risking costs may be reduced in respect of, for example, mortality assumptions, the proportion of members married (on death or retirement depending on the scheme's definition) and the ages of spouses.

Data cleansing can help with these issues if it fills in the gaps such as dates of death, marital status, spouses' dates of birth and even something as simple as postcodes. Data cleansing could also reduce the likelihood of expensive surprises later, such as having to pay additional contributions for previously unknown benefits at a time when funds are not readily available.

Data cleansing is, therefore, crucial to ensure that trustees can run a successful de-risking exercise.

Appropriate investment strategy

The latter part of 2008 bore witness to stock markets across the world recording massive falls, spreads on corporate bonds soaring in response to ongoing concern about the stability of the financial system and longer-term concerns about worldwide economic conditions. Although financial conditions have since settled down considerably, financial volatility is still an ongoing issue having to be managed.

Investment strategy plays an important role within a de-risking flightpath, but for any scheme, whether considering de-risking or not, investment risk and reward should be frequently monitored as good practice. Establishing a regular forum where the trustees and sponsor can discuss investment risks, ideally using risk metrics to form the basis of the discussion, can help to ensure that both parties are comfortable with the level of risk in place and how that risk will help them achieve their ultimate funding goals.

The major thrust of investment de-risking in the past has been to match assets to liabilities and

to understand the scheme's risk profile. Critical risks typically include exposure to changes in inflation expectations, interest rates and investment returns. Liability-driven investment strategies focus on creating a pool of assets that is well matched to the likely cash flows of the pension scheme.

Often trustees also wish to put in place a framework to monitor and act on investment performance. One option available is to use trigger points to ensure that any exceptional gains are transferred into 'safer' assets at an appropriate point. Trustees, in conjunction with their advisers, can set an upper and lower trigger point for funding. If the funding level moves above a certain point, the surplus can be placed into a lower risk strategy to lock in the gains. Similarly, if the funding level falls below a minimum trigger point, the scheme's asset allocation strategy can be reviewed.

Specifically when contemplating investment strategy before additional de-risking exercises, the scheme needs to balance the long-term investment strategy versus potential shorter-term transactional requirements. For instance, obtaining advice on portfolio structures that can more easily be transferred to an insurer before a buy-in or buyout may be quite valuable.

Legal considerations

A trustee's role is to act prudently and responsibly while operating the scheme in accordance with the scheme's trust deed and rules. Trustees must at all times ensure they look after the best interests of their members and this responsibility extends across all the activities undertaken during the course of a pension scheme's lifetime, including any de-risking exercise.

Part of the preparation in advance of a de-risking exercise should, therefore, be that the trustees confirm and are able to demonstrate that they have the power to complete the de-risking exercise, bearing in mind any restrictions that apply under the trust deed and rules of the scheme and pensions legislation.

The trustees should also assess the specific benefits that are to be secured. Where the benefit structure is complex, for example where different

rates of annual pension increases apply due to changes over time, the trustees should determine if this contractual arrangement needs to be replicated or whether there are alternative solutions that could be considered.

It is particularly important to consider benefit features that are specifically at the trustees' discretion. Any de-risking exercise is unlikely to extend the discretionary powers to a third party or the members, and therefore a decision is needed as to whether to secure the discretionary benefits as an entitlement or to stop the discretionary benefit entirely.

FLIGHT CONTROLS

When a plan is agreed there needs to be an implementation process in place. This could take the format of formal project management or a more informal approach of meetings held at predetermined strategic points in the de-risking flightpath at which progress against plan can be discussed and monitored.

The plan should also consider including market or funding triggers so that trustees and sponsors can take advantage of favourable market conditions for a variety of future de-risking opportunities.

However, the plan needs to be adaptable – situations will arise that require a review and there ought to be an agreement on what might cause a plan to veer off course. Proposed changes in legislation may require manual intervention to ensure the proposed route is still appropriate and viable. Changes in direction may also be required as a result of corporate activity, changes in senior management, weakening or strengthening of the sponsor covenant or amendments to the scheme itself.

CONCLUSION

Consideration of de-risking is an important part of pension scheme management in today's financial environment. Deciding not to de-risk is as significant a decision as deciding to embark on a de-risking journey. It should only be made

following due consideration of the risks faced by the pension scheme and a consensus that should the worst occur the sponsoring employer is sufficiently financially secure to underpin the promises made to members with regard their accrued benefits.

If de-risking is determined to be the appropriate path, consideration of the asset and liability risks faced by the scheme is essential. It should be noted that each de-risking step contributes to the journey towards the final destination with activity in one area potentially having an impact on future de-risking activities. Consequently, no one de-risking exercise should be considered in isolation to other subsequent steps or the final goal.

To ensure the plan for de-risking is adhered to, it is important to document a plan and ensure progress against key milestones is monitored. However, that should not blind trustees and sponsors to the fact that de-risking is a dynamic process – circumstances may change along the way and therefore the essential foundations of a good governance structure will allow trustees and sponsors to adapt quickly when changes occur.

The end goal is to secure pension benefits for the lifetime of members and their beneficiaries, which is in the interest of all stakeholders involved.

REFERENCES AND NOTES

- 1 The Pensions Regulator and Pension Protection Fund. (2010) The Purple Book – DB Pensions Universe Risk Profile 2010.
- 2 PricewaterhouseCoopers. (2010) Fresh wave of pension scheme closures expected as 94 per cent of employers intend to reduce or axe current defined benefit provision, press release, 14 June 2010.
- 3 The Pension Protection Fund. (2010) PPF 7800 Index. 31 October 2010.
- 4 Office of National Statistics. (2010) Life expectancy continues to rise. 30 September 2010.
- 5 Mercer. (2010) FTSE 100 pension scheme longevity assumptions increase for fourth consecutive year. 3 August 2010.
- 6 The Pensions Regulator. (2006) Regulatory Code of Practice 3. Funding defined benefits.
- 7 The Pensions Regulator. (2010) Regulatory Guidance – Record-keeping.