Defined Benefit Pensions
Preparing for the end-game

Most corporate sponsors have already considered high level options for de-risking their exposure to defined benefit (DB) pension liabilities. The result being that the vast majority of DB schemes in the UK are closed to new entrants, and almost half are closed to new benefit accrual.

Closing a DB scheme to new members immediately sets a deadline to achieve a low risk position before benefit out-go can become a strain on the funding level. This is because as schemes become more cashflow negative, a short-term funding shock can soon escalate into a longer-term problem. After a funding shock the scheme will still be paying pensions out at 100 pence in the pound, while now holding much lower reserves. This can create a vicious downward spiral of falling funding levels.

As a result, and although most DB schemes must continue to focus on eliminating funding deficits, trustees and corporate sponsors are also increasingly looking to prepare for the low risk phase.

DE-RISKING OPTIONS
The full range of de-risking options available is extremely broad, but some commonly adopted approaches can be summarised as:

(i) Managing investment risk – through reducing exposure to risky assets, diversifying the risky asset exposure that remains, hedging the interest rate and inflation risks inherent in DB liabilities, and cashflow matching.

(ii) Hedging longevity risks – using longevity swaps, or more commonly purchasing bulk annuities from an insurer (‘buy-in’).

(iii) Liability management – including retirement flexibility, offering enhanced transfer values and pension increase exchanges.

(iv) ‘Buy-out’ – the ultimate settlement of all liabilities with an insurance company.

Buy-out is likely to be the preferred end-game for all but the very largest schemes. The regulatory framework that insurers operate within, the substantial capital they hold to back liabilities, and their ability to pool risks makes buy-out a very attractive option for trustees who wish to safeguard their members’ benefits in the most secure framework possible.

However, whilst some schemes will be able to jump straight to the option of buy-out with the support of their sponsor, many will pursue options (i) to (iii) as part of a longer de-risking journey.

So, how do you ensure you undertake that journey in the most efficient way?

PLANNING YOUR DE-RISKING JOURNEY

1. Take a holistic approach
It is important to recognise that it can be very easy to do sensible things in different pieces of a DB scheme’s portfolio, which might not then make sense when you consider the overall picture. A holistic approach is needed.

2. Ensure an appropriate governance framework
It is important to be dynamic - the cost of protecting against risks varies considerably depending on market conditions, and you need to be ready to lock-in when the time is right. You also need to avoid the trap of being complacent when markets are calm, as often that is the best time to consider protection against the factors which have the biggest impact on DB schemes.

3. Consider commercial dynamics
You need to understand the commercial dynamics of the markets you are operating in, particularly when it comes to things like buy-in and buy-out. These are insurance
products, and insurance companies operate in a complex regulatory environment which means obtaining the best price isn’t always a simple function of competitive supply and demand factors.

We expand on some of these points on the following pages with the aid of some simple case studies.

**CASE STUDIES**

1. **Take a holistic approach**

   In figure 1 (A) we show a £250m scheme which has already tackled some of the risks inherent in DB liabilities through the use of liability-matching government bonds, invests in corporate bonds to provide additional liability risk protection and enhanced yields, and holds a broad portfolio of equities to achieve the growth necessary to close its funding gap.

   In a ‘bad year’ (taken to be a 1 in 20 event) the deficit in this scheme might be expected to increase by £43.5m – a significant potential funding shock.

   Most UK DB schemes can still achieve significant levels of de-risking by managing investment risk, and this scheme is no different. A good start has been made, but more can be done. By diversifying the return-seeking asset exposure, improving interest rate and inflation protection using a bespoke liability driven investment (LDI) approach, and making better use of corporate bonds it is possible to reduce the funding shock risk to £31.4m, representing an almost 30% improvement (B).

   What has been achieved with the improved LDI approach is a more accurate replication of the scheme’s liability exposures, but also greater ‘leverage’. The assets have been invested in funds that provide around £3 worth of protection against liability risks for every £1 invested. This makes the improved approach incredibly capital-efficient: as little capital as necessary is devoted to protecting against risks so that the maximum capital possible remains available to seek returns in a risk-controlled way. The result is a significant risk reduction for the trustees and the scheme sponsor.

**Figure 1. Considering risk management holistically**

A. Initial portfolio

B. Improved portfolio with reduced investment risk

C. Risk-managed buy-in – interest rate and inflation hedging adjusted around buy-in

D. Increasing buy-in size impinges on ability to hedge interest rate and inflation risk
This de-risking can be enhanced further if it is supplemented with a buy-in. An appropriately sized buy-in can preserve the risk reduction achieved, whilst adding the additional benefit of hedging the longevity risk of the liabilities covered by the insurance policy (C). Many schemes are achieving good pricing on buy-ins too, in some cases less than the actuarial reserves being held to meet the liabilities insured.

However, it is sometimes possible to have too much of a good thing. Depending on a scheme’s specific circumstances, a buy-in that is ‘too big’, could increase risk again (D). This is because, while buy-in policies provide longevity protection, they only provide £1 of protection against liability risks for each £1 invested in the buy-in policy. This reduces the ability to hedge the interest rate and inflation risks inherent in DB liabilities when compared to an LDI approach.

You therefore need to establish a framework which joins investment strategy up with liability management and settlement activity, as that will improve your ability to consider any potential impact on the wider portfolio.

2. Ensure an appropriate governance framework
Last year we saw a significant rise in the number of DB schemes undertaking member transfer exercises. This presents new challenges around hedging interest rates and inflation risks associated with uncertain liabilities, and managing portfolio liquidity.

For example, one of our clients reduced their liabilities by over 20% during the year. The client gave us discretion over the portfolio, and by working closely with the Scheme Actuary and administrator to understand member take-up rates, we were able to anticipate the lower liabilities and use our discretion to adjust the liability hedge in real-time. This meant that the scheme’s investment strategy always remained in sync with the true liabilities of the scheme, and there was sufficient liquidity to pay the transfer values without causing problems in the portfolio.

Adopting a governance framework for your DB scheme that allows you to be dynamic is vital. This will enable you to protect against emerging threats, but will also allow you to capitalise on the opportunities which may present themselves across any of the de-risking options we have covered here.

In particular we see an increased appetite for gradually reducing DB liabilities through tranches of buy-ins / buy-outs with an insurer, and this requires a dynamic, joined-up approach to ensure it works effectively.

3. Consider commercial dynamics
As mentioned above, insurance companies operate in a complex regulatory environment where achieving the best price isn’t always a simple function of competitive supply and demand dynamics.

Insurers hold capital to back the business they write - which is one reason why the insurance framework is so attractive for trustees looking to secure liabilities - and Solvency II means the assets types they hold to back their bulk annuity contracts will have a material impact on the price they can offer.

If you demanded that an insurance company write you a bulk annuity contract tomorrow, they would likely have to back that contract with easily obtainable high quality corporate bonds. The price quoted would then reflect the fact they are investing in relatively low yielding assets.

However, if you gave the insurance company time to carefully source a portfolio of higher yielding secure income assets allowable under Solvency II (such as lifetime mortgages, infrastructure assets or property debt) then the insurer could pass the benefit of those higher yields on to you in the premium quoted.

Similarly where insurers reinsure their longevity risk in the reinsurance market, giving the insurer time to source the best value reinsurance facilities allows them an opportunity to pass the benefit back to you.
CONCLUSION

We believe a flexible approach to managing the journey to a DB scheme’s low-risk run off phase is vitally important. All schemes’ situations are different and will require a bespoke approach to preparing for buy-in or buy-out.

The LGIM fiduciary management team works closely with L&G’s buy-in / buy-out specialists to integrate risk management in investment portfolios.

For our fiduciary management clients we can provide and monitor pricing for a buy-in or buy-out to assist in the formulation of strategy even though an actual transaction may be some years away. The scheme’s journey plan can then be structured to target that pricing, and the return target set to close any residual funding gap.

This provides a dynamic end-game-focused strategy for DB pension schemes, allowing them to manage their risks in the most efficient way whilst also capturing opportunities as they present themselves.

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