Eliminating unrewarded risk from defined benefit (DB) plans is the ultimate challenge for all trustees and scheme sponsors.

Many solutions exist to help schemes reduce risk, and the market continues to expand to include schemes of all shapes and sizes.

There is also greater focus on the part of The Pensions Regulator (TPR) to encourage trustees to effectively implement de-risking strategies by viewing their plans holistically.

In particular, in 2015 TPR introduced Integrated Risk Management (IRM) guidance, which expects trustees to consider the interrelationships between funding, investment and sponsor covenant when assessing risk. TPR has continued to develop and promote the importance of this approach.

IRM is more important than ever, given the unpredictable political and economic climate in which today’s DB plans operate. The ability to act quickly and effectively to remove risk and secure funding is paramount.

By understanding the de-risking opportunities available and recognising when these can be brought into force, trustees can provide a more certain future for their members. We are already seeing de-risking projects where value is created for all parties by coordinating and combining the different solutions available [see box on page 6].

Although each scheme has its own specific funding target and not all de-risking options will be appropriate, the rapidity with which new solutions evolve means keeping abreast of the opportunities available is key to successful pension risk management.

MEMBER OPTIONS

An obvious starting point for a de-risking strategy is with member options. These have long formed part of de-risking plans, but recent pension reform, which has allowed defined contribution (DC) but not DB members to draw their pension pots with complete freedom from April 2015, has rejuvenated this option.

More DB members are considering switching to DC plans as they approach retirement to take advantage of pension freedom and choice. A code of practice endorsed by TPR has helped remove fears of mis-selling and has given plan trustees and sponsors clear guidance on how member options should be run, including clear communication of the offer and provision of independent advice. This reinforces the message that member options are a legitimate means of reducing plan risk and increasing member choice.

The three key member options are at-retirement choice or retirement flexibility (ReFlex); enhanced transfer values (ETVs); and pension increase exchange (PIE). Further types of member options include paying small pots as cash sums, either on a regular basis or on winding up a plan.

ReFlex: This allows members to transfer their DB pot to a DC arrangement at the point of retirement to capitalise on pension freedoms. From the trustee/sponsor point of view, ReFlex is beneficial because DB liabilities and future investment and administration costs are reduced. It can also improve the funding position.
ETVs: DB members transfer to a DC plan some time before retirement, which means funds need to be invested at the individual’s risk before the expected retirement date. Members are often offered a financial enhancement to compensate for taking that risk and to encourage take-up. As with ReFlex, ETVs reduce DB plan liabilities along with future investment and administration costs but may negatively impact the company’s profit and loss statement in paying for the enhancements. However, the positive funding impact against potential longer targets, such as buyout, and the significant reduction in risk for the plan and sponsor typically offset any accounting concerns.

PIE: Members are offered an immediate uplift in their pension, and in return, they give up future nonstatutory increases in their retirement benefit. PIE helps members access a greater proportion of their pension in the earlier stage of their retirement, when they are likely to be more active, but they could be worse off later on. PIE reduces inflation and longevity risk, and can have a positive impact on the funding position without requiring a cash injection.

Used in conjunction with other risk-management tools, member options can provide powerful propulsion towards a full buyout, but finding the right combination will depend on each individual plan’s unique circumstances and experience.

Increasing life expectancy has been a major factor in rising deficits over recent periods. Unanticipated increases in life expectancy have added approximately £250 billion to UK private sector liabilities over the past 10 years alone. Although CMI 2016 indicates that these accelerating improvements may have stalled, it is not clear whether this is a temporary or more longer-lasting change. The risk remains, yet unlike other risks faced by plans such as equity and interest rate risk, longevity risk is typically completely unhedged.

Given current market conditions, longevity hedging represents an important de-risking option for trustees and sponsors, not least as plans can retain asset flexibility and continue to seek returns to close the funding gap. The range of solutions has widened and now provides a greater choice with innovative approaches that are available and affordable for many more schemes. It is also now possible to convert a longevity swap to a bulk annuity, and doing this interim step can lead to attractive pricing.

Until recently, longevity swaps were available only for larger schemes with at least £500 million of pensioner liabilities. However, Mercer has developed a streamlined solution in conjunction with Zurich to enable smaller schemes to transact. Other potential options are also available in the market.

Additionally, efforts have been made to reduce the cost of transactions, either by reducing the role of or by entirely eliminating the intermediary that typically sits between the scheme and reinsurers — for example, by using captives or pass-through solutions.

Now is a good time for trustees to revisit the longevity hedging market and assess whether the latest developments have created appropriate and affordable de-risking opportunities.

LONGEVITY HEDGING

Fitch Ratings described rising life expectancy as a greater threat to scheme funding than low interest rates, yet we believe this risk is perhaps less well appreciated.
The bulk annuities market continues to evolve. Better and more effective means of transferring pension risk to insurers have emerged to assist in overcoming both persistent and new challenges.

2016 was a relatively slow year for bulk annuity transactions, but we are seeing the pace hot up substantially in 2017.

We see the bulk annuity market providing solutions for schemes of all sizes, with deals ranging from as small as £1 million to well in excess of £1 billion and across all types of transactions.

Despite the prevailing headwind of low-yielding and volatile markets, insurer pricing remains attractive. We’ve seen aggressive pricing for deals involving around £100 million or more of pensioner liabilities, where insurer pricing remains significantly lower than the cost of backing those same liabilities using gilts and, in a number of cases, below gilts +0.5%.

However, the difference between the highest and lowest insurer pricing can be in excess of 10%, so ensuring that your scheme achieves the greatest level of engagement with the largest number of insurers over time maximises the chances of receiving a compelling offer.

Alongside meeting a growing demand for traditional buyout and buy-in solutions, insurers are innovating to meet a wider variety of scheme specific circumstances.

We have already seen a next-generation version of a deferred premium structure, whereby a scheme pays what it can afford now for a bulk annuity, with the balance of the premium being paid gradually over five years or so. Meanwhile, medically underwritten bulk annuities have grown in popularity over the past two years as better-quality data have widened opportunities for insurers to attractively price a buy-in or buyout.

Initially, this was deployed by underwriting entire pensioner populations for smaller pension schemes. Now we’re seeing a growing theme in the use of “top slicing” deal structures, whereby risks concentrated within the small number of the largest liabilities among the pensions in payment are subject to a medically underwritten buy-in.

In the absence of medical and lifestyle information, alongside an increased need for insurers to reinsure their longevity risk exposures, an insurer would need to be relatively cautious regarding the life expectancy of members with large pensions. The additional data gathered through a medically underwritten top-sliced pensioner buy-in can have material value in insuring these individuals at a better price.

Under any of these approaches, it is possible to combine member options with a bulk annuity (or, indeed, a longevity swap) to reduce any funding strain and potentially achieve better pricing as part of a wider journey plan.
Understanding risk in a holistic way is the first step towards de-risking a scheme. Applying integrated risk management lays the foundation on which trustees and corporate sponsors can move towards a more stable and secure funding regime.

The solutions available for de-risking a scheme are ever-expanding, and new opportunities to improve funding positions continue to emerge. Trustees need to keep abreast of the de-risking market and be ready to take action as and when market conditions allow.

De-risking strategies are most effective when they combine a number of options, and trustees should create a clear plan that includes all the relevant solutions and sets a time at which it is most appropriate to take action.

Ultimately, it is no longer a question of whether a scheme should de-risk using these techniques; it is a question of when.

A high-profile example of pension scheme financial re-engineering was the £3.5 billion buyout completed by Philips at the end of 2015, which brought together ETVs, a PIE exercise, winding-up lump sums and bulk annuities. This was a win-win-win: 1) members benefited from options they wouldn’t otherwise have had, 2) the trustee got the deal it wanted and 3) the sponsor reduced its costs. And, of course, the insurer got a deal that it might not otherwise have won.
HOW MERCER CAN HELP

Mercer is a leader in DB risk consultancy, advisory and fiduciary management, assisting trustees, pension managers and sponsors. We provide our clients with a holistic approach to pension risk management that aligns strategy with the scheme’s overall funding status and goals and is in line with the Integrated Risk Management framework. Our team of DB strategists, actuaries and investment advisors have the expertise and experience to create customised and innovative DB solutions for your scheme that make use of all available levers to best manage and mitigate risk.

If you would like to find out more, visit pension-insights@mercer.com or contact us at +44 (0) 20 7178 5640.