LCP INSIGHT CLARITY ADVICE

LCP PENSION BUY-INS, BUY-OUTS AND LONGEVITY SWAPS 2012

Over 500,000 members of DB pension plans now have their benefits insured through a buy-in or buy-out.

Lane Clark & Peacock LLP Trustee Consulting Investment Consulting Corporate Consulting Insurance Consulting Business Analytics www.lcp.uk.com

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For further copies of the report, please download a PDF copy from our website www.lcp.uk.com/buyoutreport or email enquiries@lcp.uk.com or contact Emma Ingham on +44 (0)1962 870060.

LCP's market leading de-risking advice has been widely recognised in 2011 and 2012:

LCP Pension Buy-ins, Buy-outs and Longevity Swaps 2012

This is LCP's fifth report for finance directors, trustees and the other senior decision makers responsible for managing the costs and risks associated with pension plans. Our objective is to capture key developments and opportunities in the market for buy-ins, buy-outs, synthetic buy-ins and longevity swaps.

Clive Wellsteed
Partner
LCP

We have helped our clients lead the way in de-risking using buy-ins and buy-outs – from the first £100 million pensioner buy-in by Hunting plc in January 2007 through to an innovative £830 million transaction in December 2011 to provide benefits to members in the Uniq plc Pension Scheme.

Key findings

2011 saw over £10 billion of buy-ins, buy-outs and longevity swaps for the first time in the UK
Despite difficult economic conditions, demand for pensioner buy-ins and longevity swaps was buoyant and contributed to year-on-year market growth - up from £8.3 billion in 2010.

£12.3bn
Record business volumes in 2011.

The benefits of over 500,000 members of DB pension plans are now covered by insurance policies - either through a buy-in policy held by the trustees or a buy-out policy in the member's own name
This number is set to pass one million - or nearly 2% of the UK population - over the next five years.

550,000
The number of pension plan members whose benefits are covered by a buy-in or buy-out.

More major names transacted in 2011
Significant buy-in and buy-out transactions in 2011 included the Law Society, the London Stock Exchange, Home Retail Group and the Uniq plc Pension Scheme. Major longevity swaps were concluded by British Airways, Rolls Royce, ITV and Pilkington.

Pensioner buy-in pricing improved significantly over 2011 for pension plans holding gilts
Rising corporate bond spreads contributed to competitive pricing from insurers, whilst pension plans holding gilts were able to lock in strong returns over 2011 by purchasing a pensioner buy-in. This led to a flurry of activity, with LCP completing no less than seven buy-in transactions in the final days of 2011. Conditions for pensioner buy-ins continue to be favourable in early 2012.

0%
Typical premium of pensioner buy-in price over gilts-based valuation in early 2012.

Affordability of full buy-outs remains low
The combination of subdued equity markets and rock-bottom gilt yields has meant that full buy-outs remain relatively rare. We remain of the view that should investment markets rally, demand for full buy-outs has the potential to quickly outstrip supply.

Affordability of pensioner buy-ins, buy-outs and longevity swaps for a typical pension plan

Pensioner buy-in	Longevity swap	Full buy-out
Conditions most favourable if pension plan holds gilts.	Longevity swap pricing tends to be relatively stable over time.	Most pension plans do not hold fully matching investments, so falling gilt yields and subdued equity markets have driven up buy-out deficits.

Source: LCP

£14bn

Total pension liabilities covered by longevity swaps in the past three years.

2011 saw a renaissance in longevity swaps for pension plans

Although transaction complexity remains an issue, over £7 billion of liabilities were hedged using longevity swaps during 2011, including the first transaction by Legal & General. Demand remains robust from larger pension plans where rising life expectancy is a significant financial risk. Streamlined longevity swap solutions for smaller plans are also in development from some providers.

£40bn

Total volumes of buy-ins, buy-outs and longevity swaps since 2006.

Solvency II for pension plans looms on the horizon

There is much debate about the EU proposals to apply "Solvency II", the insurance style reserving regime, to pension plans. The proposals point towards higher funding targets for pension plans in the future. Whilst the final position may be more benign, the direction of travel is clear and some companies may decide to take the initiative by bringing forward the timing of a buy-in or buy-out transaction.

Pension plans are increasingly planning for the "end-game"

Insurance companies are responding to this by designing structures that give pension plans certainty on the cost of a buy-out at a set date in the future, providing time to close the funding gap through investment returns and company contributions in the meantime.

£830m

Buy-in transaction negotiated by LCP for the Trustee of the Uniq plc Pension Scheme in December 2011. See page 18.

Pension plans transacting successfully in 2011 moved quickly to take advantage of favourable market conditions

The innovative contract agreed between the Trustee of the Uniq plc Pension Scheme and Rothesay Life was a good example of this and followed a restructuring agreement approved by the Pensions Regulator. By moving quickly to lock in favourable pricing, LCP helped the Trustee to secure benefits at least as good as Pension Protection Fund compensation for over 20,000 members.

A major longevity swap transaction was completed in the capital markets

A €12 billion longevity swap transaction was announced by Deutsche Bank in February 2012 with Dutch insurer AEGON, which was notable for passing a significant amount of longevity risk into the capital markets for the first time - this demonstrates how the capital markets can help insurers to manage the longevity risk they are taking on and is positive news for market capacity from the perspective of UK pension plans.

LCP is a leading specialist adviser on buy-ins and buy-outs, with a proven track record of executing transactions of all sizes, including:

Ofcom, Press Association, Hunting, GSK GlaxoSmithKline, Morgan Crucible, Home Retail Group, Uniq

Charlie Finch
Partner
LCP

Looking ahead, we will start to see a sharper focus by companies and trustees on "end-game" planning. This will require insurers to provide de-risking structures that give pension plans greater certainty on the ultimate cost of a buy-out, without the need for an up-front cash contribution.

Content

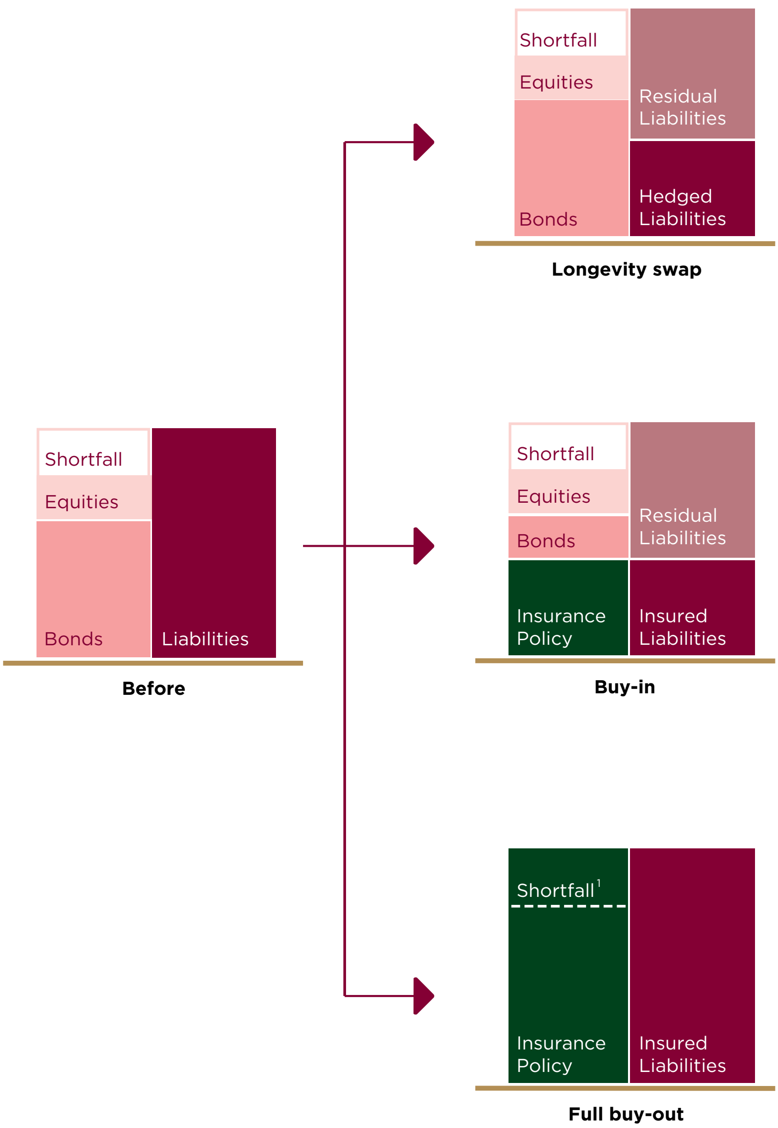
David Lane
Partner
LCP

Over 2012, we expect a continuing demand for pensioner buy-ins given the favourable pricing available for pension plans holding gilts.

Introduction: the key de-risking tools

Insurers have developed a range of tools to allow pension plans to de-risk.

There are three main options available to pension plans in this market - either a buy-in or a buy-out from an insurer, or a longevity swap from an insurer or a bank.



Longevity swap

Risks removed

Interest rate risk	Inflation risk	Asset risk	Longevity risk
✗	✗	✗	✓

Subset of liabilities typically targeted

Pensioners	Non-pensioners
✓	✗

Buy-in

Risks removed

Interest rate risk	Inflation risk	Asset risk	Longevity risk
✓	✓	✓	✓

Subset of liabilities typically targeted

Pensioners	Non-pensioners
✓	✗

Full buy-out

Risks removed

Interest rate risk	Inflation risk	Asset risk	Longevity risk
✓	✓	✓	✓

Subset of liabilities typically targeted

Pensioners	Non-pensioners
✓	✓

[1] Shortfall paid either immediately or crystallised into a series of regular known payments

[2] Diagram shows position just before issue of individual member policies

Setting a de-risking framework

Many companies would like to secure their pension liabilities in full with an insurance company through a full buy-out, but the high cost of doing so at the current time is generally not seen as a good use of shareholder funds.

In this situation, it is often helpful for companies and trustees to agree a "flight-plan" that targets full buy-out over a set time period. The aim of a "flight-plan" is to document an agreed framework for de-risking and establish the necessary governance to approve transactions over short timescales. Many of the pension plans transacting over recent years set up efficient decision-making processes well in advance of transacting.

Many flight-plans aim to gradually increase the proportion of insured liabilities over time, without unduly increasing the technical provisions at any point. The final target is a manageable cash injection to reach full buy-out at the end of the ten year period.

The chart below shows the projected buy-out cost and asset value for a typical pension plan over the next ten years. It then compares these amounts to the technical provisions used to set cash contributions.

The three stages shown in the chart below are as follows:

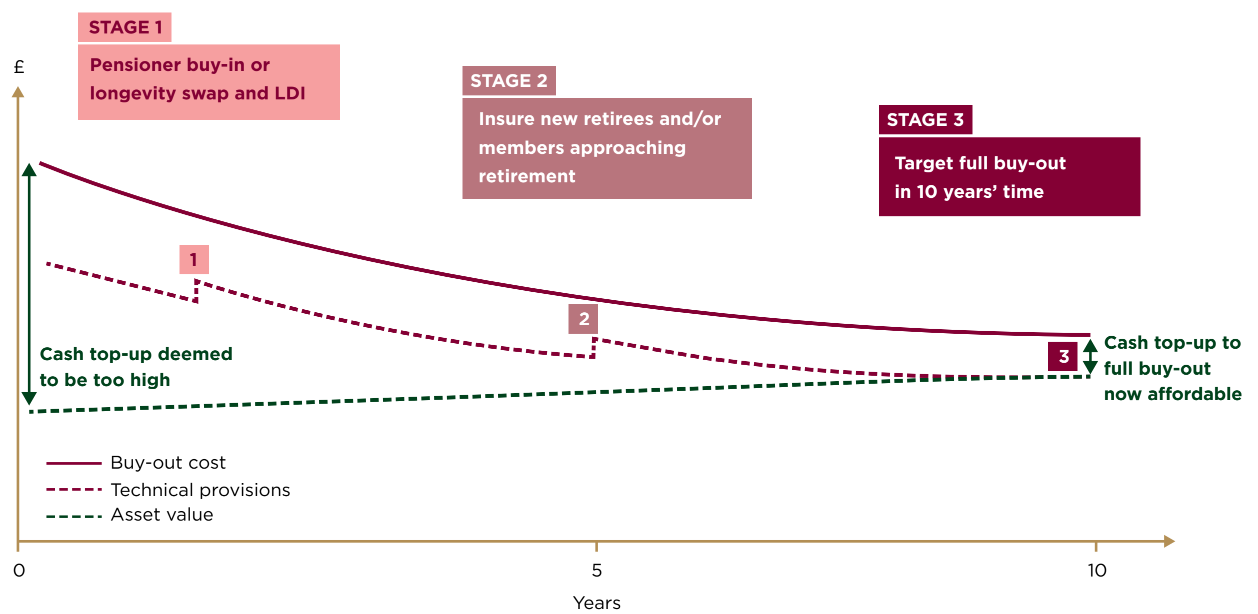
- Stage one – insure current pensions in payment through a pensioner buy-in, taking advantage of current competitive pricing.
- Stage two – insure pensioners who have retired since the original transaction and agree terms for members approaching retirement.
- Stage three – insure the remaining members, who will be ten years older than they are today and therefore more affordable to insure - this will be followed by full buy-out and payment of any cash top-up soon afterwards.

Charlie Finch
Partner
LCP

A series of well-timed buy-ins can be more cost-effective than a large buy-out at a single point in the future.

See page 24 for drivers of full buy-out for companies.

Typical flight-plan showing steps to de-risk and run-off of assets versus liabilities



What were the key 2011 de-risking transactions?

See the Appendix (page 34) for full details of transactions since 2008.

Review of 2011

2011 was a record year for de-risking, with volumes of buy-ins, buy-outs and longevity swaps exceeding £10 billion for the first time.

2011 saw business volumes hit £12.3 billion, a 50% increase compared to the previous three years at around £8 billion each. This year-on-year increase can be attributed to:

- A number of significant longevity swap transactions closing in 2011.
- Increasingly favourable conditions for pensioner buy-ins, particularly in the second half of the year.
- Two large pension plans taking advantage of favourable conditions to buy out and avoid entering the Pension Protection Fund (PPF).

Highlights of 2011 - longevity swaps

Longevity swaps accounted for £7.1 billion of the £12.3 billion of business in 2011 as large pension plans (ITV, Rolls Royce, Pilkington and British Airways) entered into transactions in the second half of the year. This allowed them to transfer large volumes of longevity risk to providers without needing to disinvest the underlying assets in volatile markets. The providers passed on a proportion of the longevity risk to reinsurers.

See page 20 for commentary on the longevity swap market.

Pension plan	Counterparty	Regime	Date	Transaction size
British Airways	Rothesay Life (Goldman Sachs)	Insurance	December 2011	£1.3bn
Pilkington	Legal & General	Insurance	December 2011	£1.0bn
Rolls Royce	Deutsche Bank	Banking	November 2011	£3.0bn
ITV	Credit Suisse	Banking	July 2011	£1.7bn
Pall	J P Morgan	Banking	February 2011	£70m

Source: Insurance company data

Legal & General wrote its first longevity swap in 2011, offering an alternative provider to pension plans considering hedging longevity risk.

Highlights of 2011: buy-ins and buy-outs

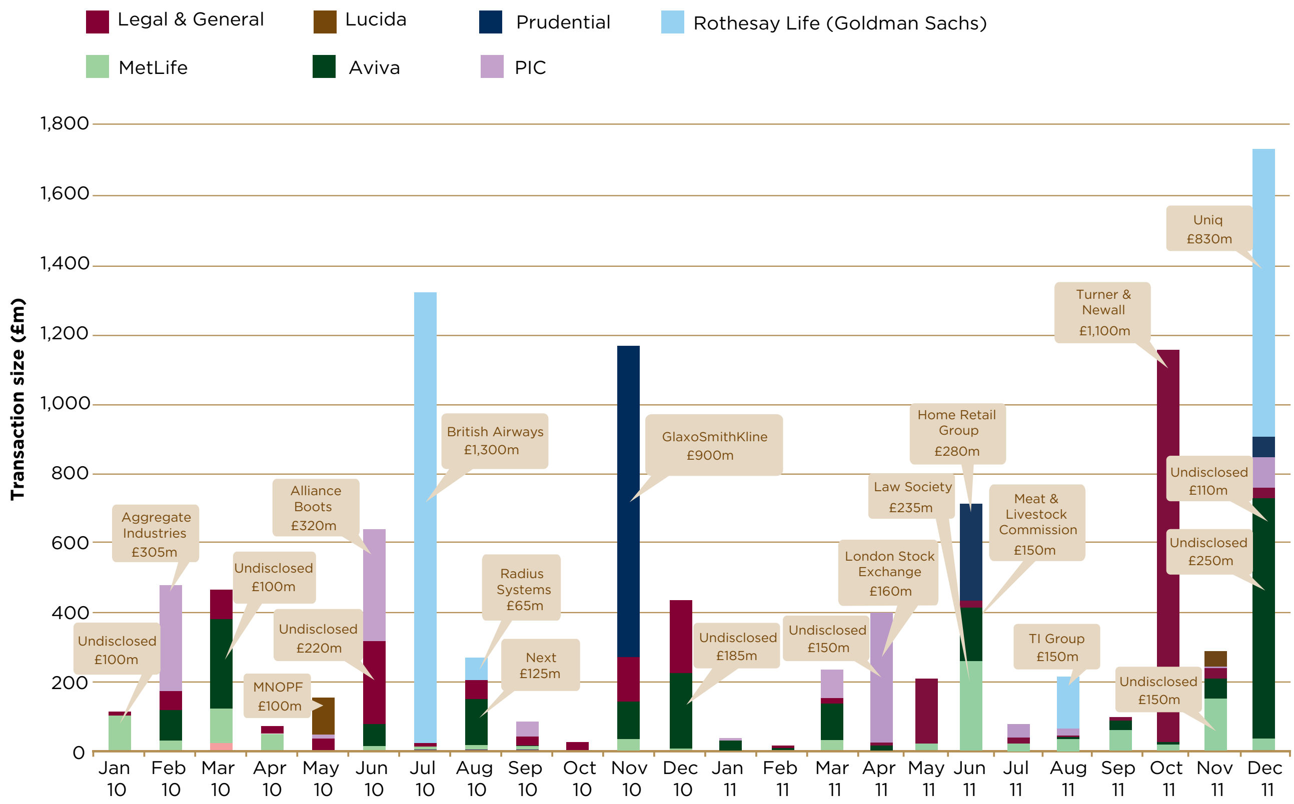
Volumes of buy-ins and buy-outs increased over the second half of 2011, culminating in two “mega-deals”: Turner & Newall at £1.1 billion in October 2011 and Uniq at £830 million in December 2011.

These two plans faced the additional challenge of needing to co-ordinate insurer negotiations with assessment by the PPF. Both plans were able to secure benefits at least as great as those provided by the PPF, by locking into favourable movements in asset values relative to insurer pricing.

Pricing was particularly competitive in the fourth quarter, driven by strong competition for business and favourable investment opportunities available to insurers, for example from high-quality corporate bonds.

LCP led the commercial negotiations for seven major buy-in and buy-out transactions in the final weeks of 2011, covering £1.25 billion of business.

Buy-out and buy-in transactions



Source: Insurance company data and company announcements

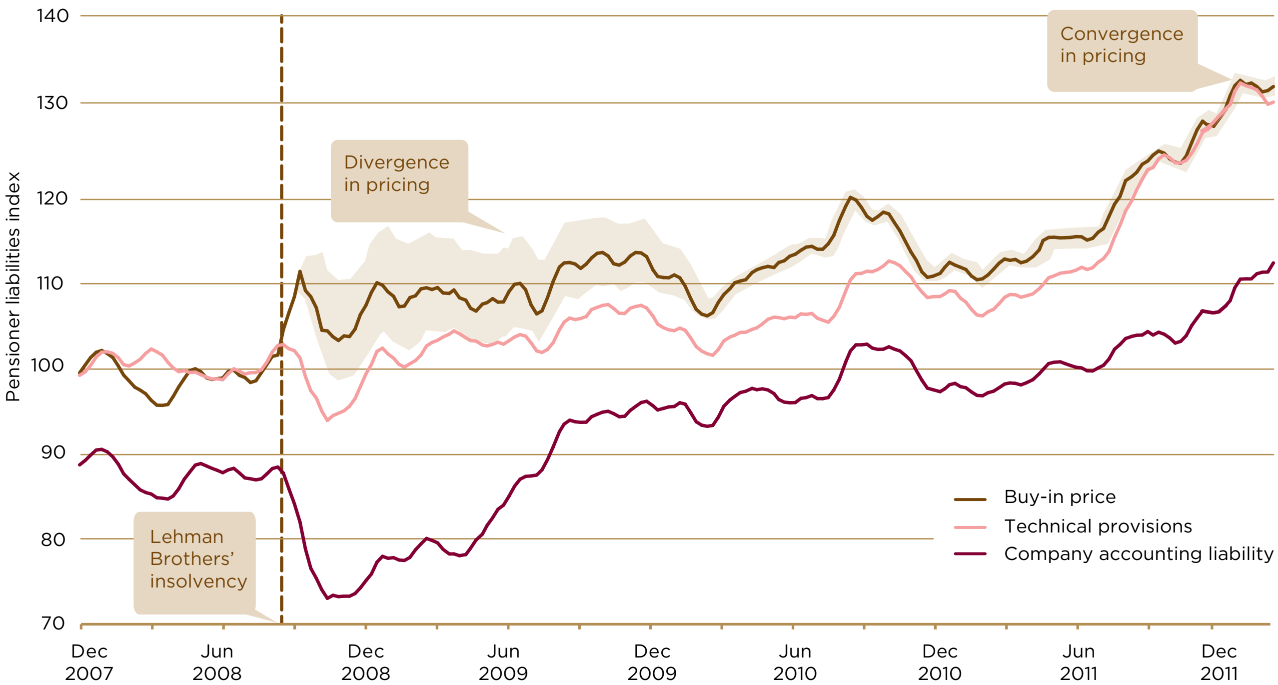
Pensioner buy-in pricing

The competitive pricing in late 2011 created a particular opportunity for pension plans holding UK government gilts, whose value rose significantly relative to the cost of buy-in.

This led to a double benefit - the gilts provided protection from rising liability values and gave pension plans an opportunity to take advantage of the best pensioner buy-in pricing relative to gilt values since 2008.

This convergence in pricing can be seen in the chart below.

Pensioner buy-in pricing



Source: LCP research

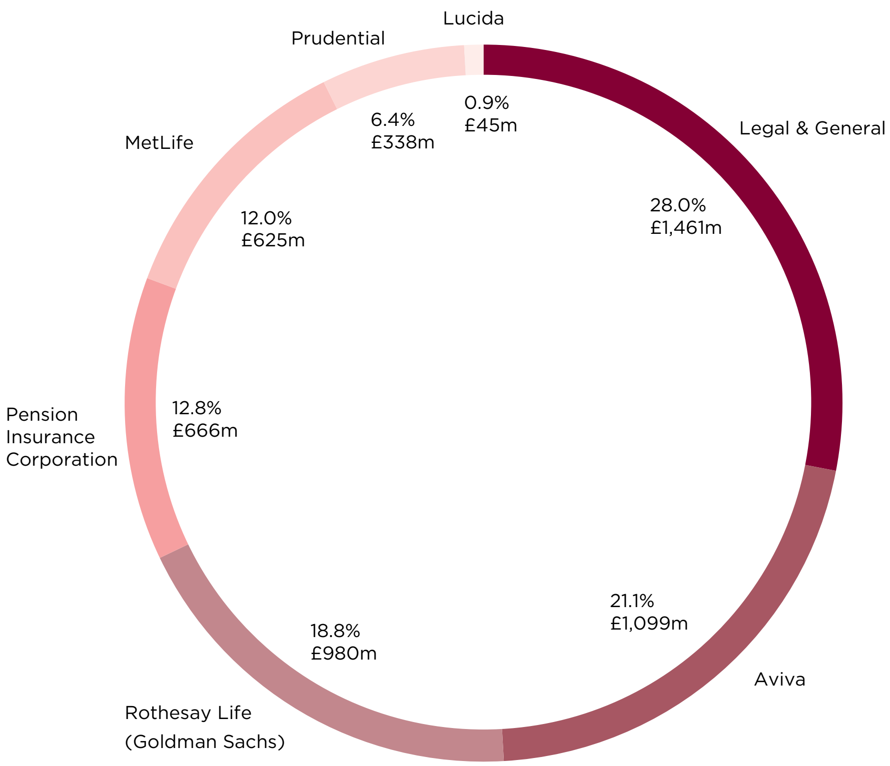
Clive Wellsteed
Partner
LCP

For pension plans already invested in gilts, current pricing means that pensioner transactions can often be closed with no impact on the funding deficit or agreed cash contributions.

Market share by provider

2011 saw insurers continuing to target different segments of the market. Five insurers – Aviva, Legal & General, MetLife, Pension Insurance Corporation and Rothesay Life – wrote over £500 million of business during the year, demonstrating a robust level of competition.

Market share (by premiums written)



Source: LCP research

Ken Hardman
Partner
LCP

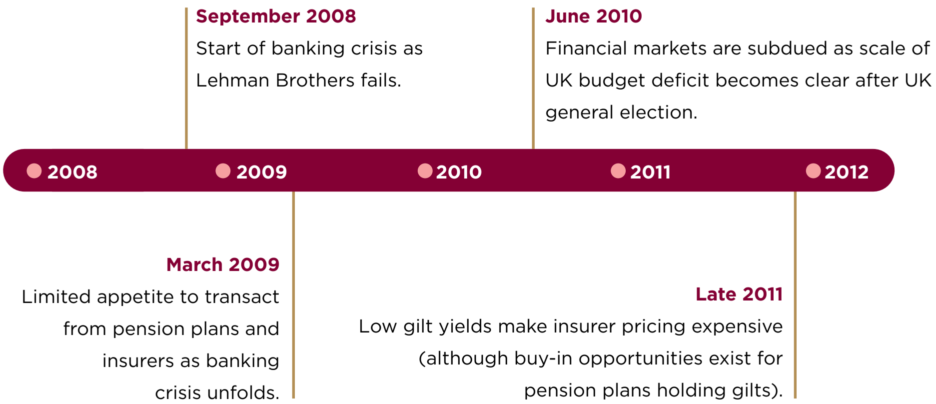
LCP's view is that the buy-in and buy-out market continues to be highly competitive, with at least three insurers typically offering competitive quotations at all sizes up to £1 billion.

Outlook for 2012

Transaction volumes have been remarkably robust over recent years against a challenging backdrop.

Our view is that the underlying demand from pension plans to de-risk using buy-ins and buy-outs is much higher than current business volumes suggest, with low gilt yields and subdued equity markets currently constraining market activity.

A challenging backdrop since 2008



Over 2012, the signs are that market competition will remain keen for pension plans in a position to transact, particularly with new providers (such as Nomura and Long Acre Life) set to enter the market for the first time since 2007.

Market competition is likely to remain keen in 2012 for those plans in a position to transact.

Looking longer term, we suspect that the real catalyst to the buy-in and buy-out market will come when pension plan funding levels improve across the board and insurance options become more widely affordable. This is likely to provide an additional incentive for insurers to develop more efficient ways to pass risk to reinsurers and the wider capital markets. This makes an interesting contrast to 2011 where some insurers chose to retain more of the risk they insured on their own balance sheets.

Richard Murphy
Partner
LCP

There is a huge pent-up demand for de-risking from pension plans. If funding levels improve, annual transaction volumes could hit £25 billion by 2017. This should provide a real incentive for insurers to increase capacity.

LCP case study: Uniq transaction

In December 2011 the Uniq plc Pension Scheme secured pension benefits with Rothesay Life in an £830 million deal.

The transaction brought welcome certainty to members; at one point the pension plan had a deficit 40 times larger than the market capitalisation of Uniq. Ten years earlier, when Uniq was created from the de-merger of the Unigate businesses, it had a market capitalisation of £200 million and no significant pension deficit.

2000 · 2009 · 2010 · 2011

2000
Uniq created from de-merger of Unigate businesses. Uniq's market capitalisation is £200m with no significant pension deficit.

31 MARCH 2009
Actuarial valuation reveals deficit of over £400m. The deficit compares to the market capitalisation of Uniq of less than £10m.

SPRING 2010
Trustee, Company and Pensions Regulator unable to construct a realistic and affordable Recovery Plan to pay off the deficit.

JUNE 2010
LCP requests initial quotations from insurers to insure PPF compensation benefit levels.

OCTOBER 2010
The Trustee switches its investment strategy to invest 100% in gilts.

MARCH 2011
Ground-breaking deficit-for-equity swap

- The Trustee implements the first ever pensions deficit-for-equity swap.
- The Trustee obtains a 90% stake in the company in return for giving up its claim on future deficit funding.
- Swap implemented via a Regulated Apportionment Arrangement – used only in exceptional circumstances and with the consent of the Pensions Regulator and the PPF.
- Scheme commences wind-up and enters a PPF assessment period.

Richard Mills
Partner
LCP

The Uniq case study offers some valuable insights. First, trustees need to recognise when it is no longer viable to take a long-term view and instead take proactive steps to maximise value for members. Second, it shows how an innovative buy-in structure can be designed to take advantage of favourable market conditions and tailored to meet the very specific needs of a pension plan.

Chris Martin
Independent Trustee Services
Chairman of Trustees
Uniq plc Pension Scheme

The policy structure designed by LCP and secured by Rothesay Life is an important stride in realising our objective on behalf of the 20,000 members of the Scheme.

OCTOBER 2011
Uniq plc is sold to the Irish food manufacturer Greencore. The Scheme receives proceeds of over £100m from the sale.

NOVEMBER 2011
LCP concludes a competitive selection process for insuring the Scheme's benefits. Rothesay Life is selected by the Trustee as the preferred insurance provider.

DECEMBER 2011
Section 143 valuation approved by the PPF.

2012

DECEMBER 2011
Trustee completes £830m buy-in transaction with Rothesay Life

- Innovative PPF buy-in deal covering both pensioner and non-pensioner members of the Scheme.
- Lock-in of advantageous pricing within one week of the selection of Rothesay Life as preferred provider – against a backdrop of volatile bond markets.
- LCP designed the policy structure to deal with the Trustee's complex requirements surrounding the data and benefit issues that accompany large legacy pension plans.
- Policy guarantees that members' benefits will be at least equal in value to PPF compensation – with the Trustee given additional flexibility to top-up benefits prior to buy-out if additional funds emerge.

Ian Mills

Partner

LCP

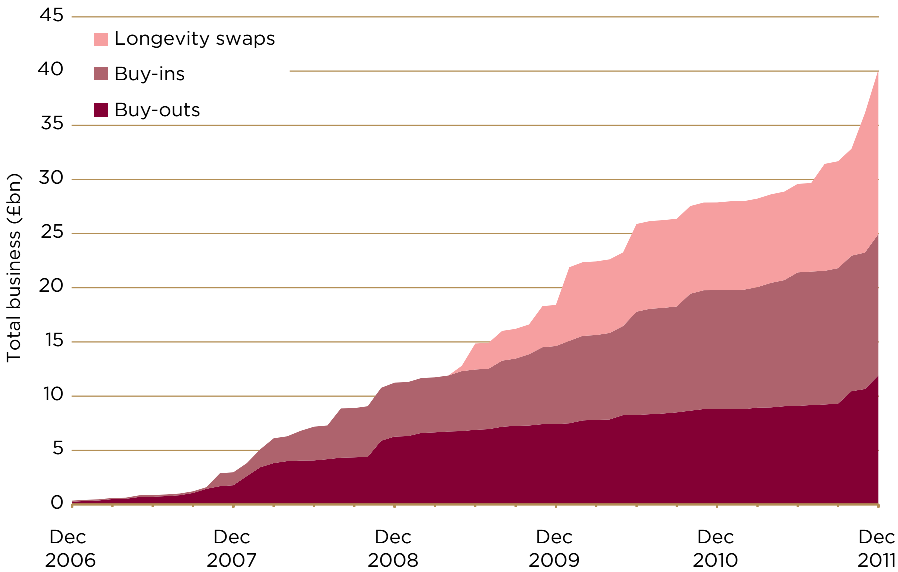
Longevity is a key risk for UK pension plans. Over the past 20 years, male life expectancy has increased by nearly five hours every day.

Longevity swaps: a renaissance?

After a quiet 15 months, the second half of 2011 saw four longevity swap transactions covering £7 billion of liabilities. Is this the sign of things to come?

The growth in longevity swaps in late 2011 can be seen in the chart below, which shows total volumes of buy-ins, buy-outs and longevity swaps over the last five years.

Buy-outs, buy-ins and longevity hedges



Source: Insurance company data

This growth has been driven by larger pension plans wanting to complement an existing strategy to hedge interest rate and inflation risk with protection against rising life expectancies. At the time of writing, some additional return in excess of gilt yields was generally needed from the underlying assets for the strategy to compare favourably with the price of a pensioner buy-in.

Ultimately, the key drivers for continued growth in longevity swaps are:

- reducing the complexity of the products, particularly with regard to collateral arrangements;
- providing a more streamlined transaction process - particularly where back-to-back contracts with reinsurers are required; and
- increasing the capacity of the longevity risk market by widening the number of ultimate holders of this risk, either through additional reinsurance or capital markets.

As these features improve, we see steady growth in the number of longevity swap transactions by pension plans, although they will continue to be much less frequent than buy-ins and buy-outs for the foreseeable future.

Longevity swaps for smaller plans

The sophisticated structures adopted so far for collateral, surrender terms and transfer to buy-out create practical challenges for smaller pension plans. Some providers – such as Legal & General – are seeking to broaden the appeal of longevity swaps to smaller plans by offering simpler standardised products.

These new developments are opening up the longevity swap market to transactions below £250 million for the first time.

The next phase of the longevity market

For the longevity swap market to reach its full potential, new holders of longevity risk will need to provide further capacity to insurers and banks. The capital markets have a role to play in providing this capacity, just as they did in other areas of insurance such as catastrophe bonds.

There are challenges in creating a longevity product that is attractive to capital market investors. In particular, these include the very long-term nature of longevity risk, the potential open-ended losses and the complexity in understanding and assessing value.

Nevertheless, progress is being made. The Life & Longevity Markets Association – an industry-wide body – has recently published longevity indices for four major countries to provide a standard platform for the trading of longevity risk in capital markets. Capital market deals such as AEGON's (see box opposite) open up new holders of longevity risk, and potentially provide much increased capacity to the market.

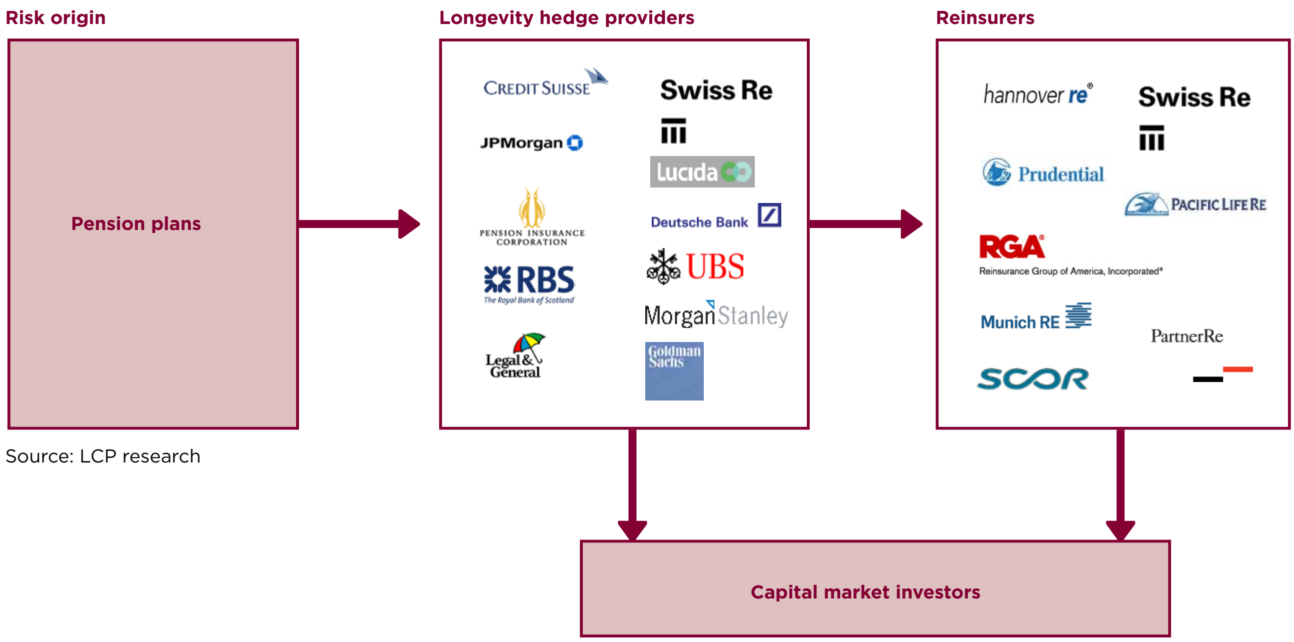
From the capital market's perspective, there is no doubt that demand exists. For some global financial institutions longevity-linked instruments provide an offsetting risk against mortality exposure they already hold (eg life insurance contracts written in the US). For other investors, they provide a return that is not correlated with equity markets so diversify their investment portfolios. Longevity-linked investments are therefore attracting considerable and growing interest in 2012.

A capital markets solution?

AEGON announced in January this year that it had reinsured the longevity risk on around €12 billion of its Dutch annuity liabilities with Deutsche Bank. This is the largest longevity risk transfer to date.

Importantly, the trade was specifically targeted at capital market investors. To achieve this the trade was limited to a 20 year term, the payments were capped and collared, and payments were linked to movements in Dutch population mortality statistics rather than individual lives.

Longevity risk transfer markets



Source: LCP research

Content

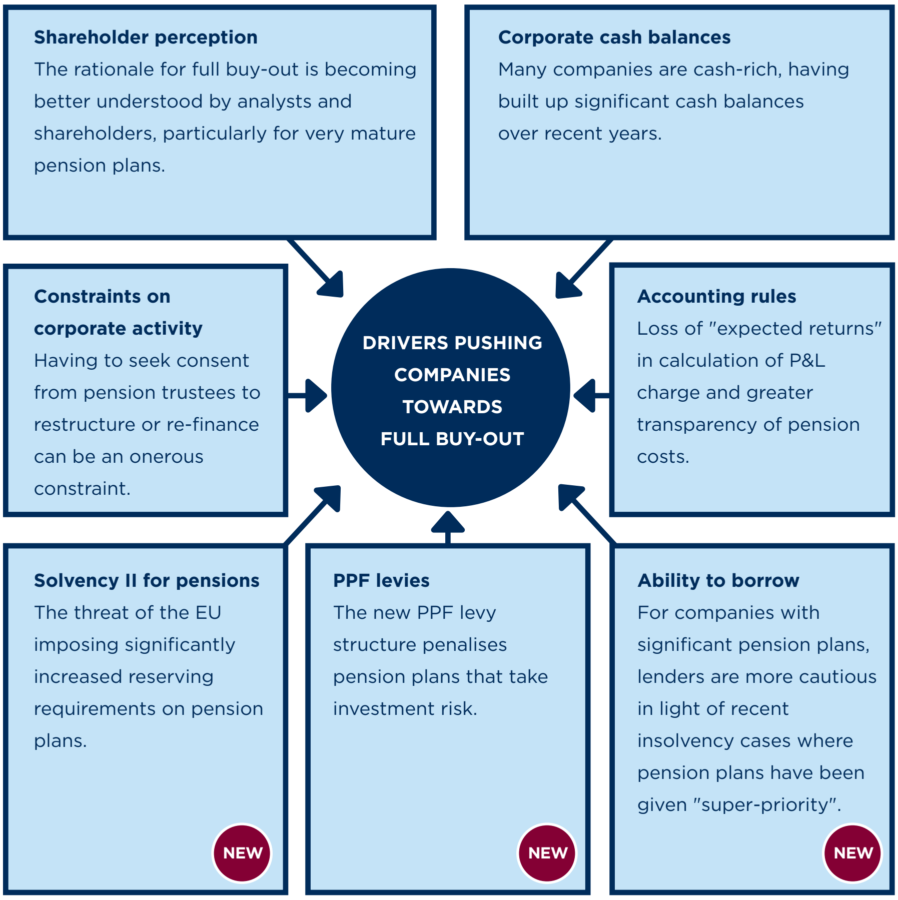
David Stewart
Partner
LCP

At LCP, we have one of the largest and most experienced buy-out advisory teams in the UK. We excel at getting transactions across the line with a strong reputation for achieving the best price and commercial terms.

Drivers for full buy-out

Companies should decide under what circumstances they would be willing to accelerate cash into the pension plan to reach full buy-out.

At the current time, the amount of cash required to meet the cost of a full buy-out is too high for most companies to justify to their shareholders, but the other elements of the business case are strong for many plc boards.



For those companies that are not currently in a position to afford a full buy-out, structures now exist that allow for the buy-out deficit to be met over a number of years, providing time to close the funding gap through investment returns and company contributions in the meantime. This can make a full buy-out of the pension plan closer than many companies realise.

Hannah Gillinson
Consultant
LCP

For most companies, it is a question of when, not if, they will take the step to buy out their pension plan in full.

Locking into an optimal transaction price

Trustees and companies can be surprised just how much insurer pricing can and does fluctuate over time.

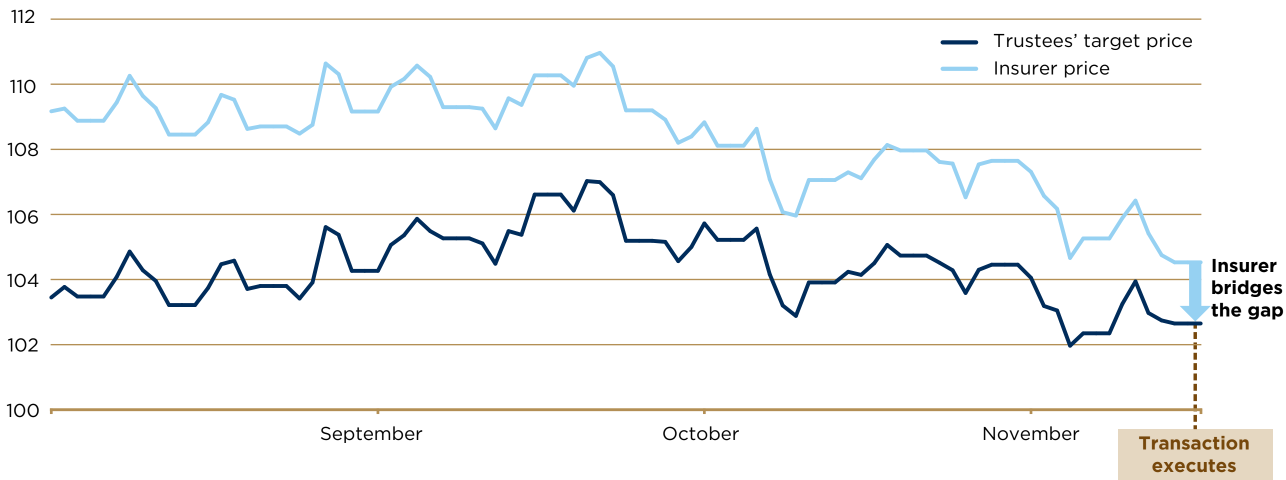
For both buy-in and buy-out transactions, a trigger-based execution strategy can be used to ensure that a transaction takes place only when pre-agreed financial metrics are met. If well designed, this can capture improvements in both financial conditions and insurer appetite.

Case study: trigger-based pricing mechanism

The following case study is for an LCP client who chose buy-out as its preferred strategy after an initial feasibility study. It then went through the following steps:

- Detailed proposals were invited from four insurers and a competitive selection process was used to narrow the field to two insurers.
- Key commercial terms were agreed with the two insurers following review of their standard contracts.
- Insurer pricing was at that stage a little higher than the desired level, so a trigger-based approach was put in place, with each insurer agreeing to monitor the target price on a daily basis.
- The transaction then went ahead with the first insurer who met the target price – through either movements in market conditions or a change in its appetite to transact, as shown in the chart below.

Importance of insurer appetite



Source: LCP analysis

Medical underwriting

The last decade has seen significant growth in enhanced annuities, where individuals obtain improved annuity prices by going through a medical underwriting process. For an individual, even minor medical conditions or lifestyle factors can lead to material savings in the cost of an annuity; market participants suggest 40% of individuals can qualify for some improvement in pricing terms as a result of this process.

In the past year, leading providers of medically underwritten annuities, such as Partnership, have started developing propositions for the buy-in and buy-out market. In addition, Legal & General has extended its existing medical underwriting capabilities to the bulk annuity market.

Whilst an intuitively attractive idea, medical underwriting introduces a range of practical challenges for trustees such as:

- the process for obtaining medical information from members and how to manage highly sensitive data; and
- avoiding cherry-picking – for example, if a pension plan insures only those lives in poor health then it is likely to be harder and more expensive to insure the remaining members at a later date.

On balance, our view is that, for the right pension plan (particularly smaller arrangements), medically underwritten quotes provide a useful additional option, so long as trustees are mindful of the challenges above.

Q1 2014

Solvency II for insurance companies becomes effective.

Solvency II for insurers

Solvency II is the new regulatory regime for insurance companies. Following a number of implementation delays, it is due to apply from January 2014. It has the potential to increase future buy-in and buy-out pricing by imposing higher capital requirements on insurers and changing the asset classes in which they invest.

Most of the key principles have been determined and insurers are already allowing for the future impact of the new regulations. However, a number of implementation and practical details are still being determined.

In practice, this means that we do not expect to see a step change in pricing for traditional buy-ins and buy-outs, but there may be a pricing impact for some contract structures for larger plans, such as collateral accounts and guaranteed surrender terms.

Solvency II for pension plans?

Recent publications from the EU have outlined proposals to introduce a regulatory regime for pension plans consistent with some of the Solvency II rules being brought in for insurers. If introduced, such a regime would have a profound impact on the way UK pension plans are managed and funded.

Whilst most pension plans may be happy for now simply to note the developments, some may have legitimate concerns about the direction of travel, which may lead them to more actively consider actions including buy-ins and buy-outs. Early movers may have an advantage in securing competitive terms from insurers.

Of course, there is a lot of political wrangling to be done before any of this is enshrined in a new European directive (which might in turn be expected to result in a new UK Pensions Act) – the key next step is a Quantitative Impact Study (QIS) which should be completed by the fourth quarter 2012.

Insuring CPI-linked benefits

Over 2011 many UK private-sector pension plans concluded that some of their benefits are now linked to the Consumer Price Index (CPI) rather than the Retail Price Index (RPI).

Unfortunately, over 2010 and early 2011 it was difficult to achieve a meaningful reduction in insurance pricing for benefits increased in line with CPI as opposed to RPI.

The good news is that insurers have now started to provide price discounts for benefits increased with CPI. The price discounts still give only limited value for the expected future difference between CPI and RPI, but it is an improving picture.

Going forwards, we expect CPI-based quotations to become more commonplace than now. However, the attractiveness of CPI pricing is unlikely to improve further until there is a much larger availability of CPI-linked assets. We understand that the UK Debt Management Office does not currently have plans to issue CPI-linked securities, so this process may take some time. In the meantime some pension plans are choosing to insure RPI rather than CPI, where possible, as it offers better value for money. A clear mechanism to move to CPI in the future is essential if the pension plan insures RPI in the initial contract.

Buy-out opportunities outside the UK

Companies are looking to reduce pension risk overseas as well as in the UK.

As more and more companies take steps to de-risk their UK legacy pension plans they are also looking to take similar steps to reduce or remove pension risk in other countries.

The UK is leading the way in pensions de-risking, but other countries have begun to follow suit, most notably in Ireland, the Netherlands and Switzerland. Canada and the USA also have fledgling buy-out markets.

Whilst the most effective way to de-risk differs by country, reflecting the different local legislation and pension markets, in almost all countries there are opportunities for companies to take steps to de-risk their pension plans. De-risking can also lead to stronger corporate governance as well as reducing the running costs and time spent operating pension plans. As operating costs seem to become an ever increasing element of pension costs, a pension buy-out can make real financial sense.

We set out below some examples of countries where de-risking is possible.

Ireland

Interest in buy-outs is expected to increase in Ireland over the course of 2012. New funding legislation is due to be released shortly and the short-term focus for companies will be to repair funding deficits. Not only will companies be faced with restoring technical reserves but the new rules are expected to require pension plans to hold additionally an explicit “risk reserve”. Many companies are likely to be reluctant to make additional cash contributions to fund this additional reserve and will look at alternatives such as a pension buy-out.

“Sovereign annuities” will soon become available providing cheaper annuities where pensioners take on the default risk associated with the sovereign bonds underlying the annuity contract. These will potentially allow creative buy-out solutions, particularly where buy-out may otherwise be too expensive.

Some new insurers have entered the Irish buy-out market, led by some of the established UK providers, and have gained some traction. With the expected increase in activity and added competition leading to more attractive pricing, the next year will be an interesting one for the Irish buy-out market.

The Netherlands

The strong funding rules in the Netherlands require companies to fund their pension plans up to around 125% of their funding liabilities. This is explicitly to allow for risk and any deficit against this target has to be repaired relatively quickly, often causing a cash flow headache for companies. Often there is little additional cost to transfer the pension liabilities – and the risks – in full to an insurer. This solution also drastically reduces the considerable ongoing costs and management time of operating a pension plan in the Netherlands.

A full buy-out will make sense for the majority of Dutch pension plans under €100 million in size. Larger pension plans may also wish to consider this option as well as partial buy-out or buy-in opportunities.

As an example, LCP helped a global hotel chain buy out its pension plan. The company faced high cash demands despite the plan being almost 100% funded. LCP identified that the company was able to transfer its entire past service liability to a well capitalised insurer at no additional cash cost. The solution included uplifting members' benefits to compensate them for the removal of possible future inflationary increases. Each year the company pays an annual premium to the insurer to meet future benefits. Ongoing administration and running costs have been significantly reduced.

Switzerland

The trend of companies ceasing to operate their own pension plans (or foundations) has increased - especially where they are relatively small in size.

In Switzerland it is possible to transfer a pension plan into a larger foundation and this has become the leading solution to reduce risk for smaller plans. The merits of transferring into a wider foundation can be to reduce or remove the risk of deficits arising which would require additional funding from the company, stronger governance, reduced insurance costs as well as significantly reducing the sizable costs and management time that operating your own pension plan requires.

This solution can therefore provide a win-win for all parties involved. A key part of de-risking in this way is to ensure that you find the right foundation to transfer into, and the best way to achieve this is to use someone with expertise and experience in this specialist area to guide you through the process. We have helped many companies consider their possible options, find their ideal solution and helped manage the transition including communication with all stakeholders.

North America

The US and Canada have a significant legacy of DB pension plans, although unlike the UK a much higher proportion remain open and the legislation governing pension plans is not as onerous. Further, most plans in the US and Canada do not include automatic indexing of benefits and, as such, the sensitivity to interest rate or longevity changes is markedly less severe than in the UK. Additionally, the US Federal government is looking at approaches to foster a dual DB/DC environment.

As a result, North America has not had the same appetite as the UK for embracing de-risking. However, there are signs of interest with a US$75 million buy-in announced in the US in May 2011. If the US market took off it could rapidly become the biggest de-risking market in the world.

In Canada the concept of a UK style buy-out, but without an employer “back-stop” of any residual risk, is being piloted with the Nortel pensioners. Legislation permitting this market innovation was included with the most recent Ontario Budget and could start a de-risking trend.

Other countries

Buy-out opportunities also exist in other countries. We have helped companies de-risk their pension plans in a wide range of countries including Sweden, Belgium, Denmark, Germany as well as further afield such as Sri Lanka and Jamaica. Whilst in these countries, local pension plan liabilities may be a small percentage of overall global pension plan liabilities, they can require disproportionate amounts of management time and adviser costs, as well as carrying financial and longevity risks. Many companies have found that the benefit of reducing risk in these countries outweighs the costs involved, and in some cases can even lead to an accounting gain or a refund of surplus.

Conclusion

When considering de-risking, companies should be aware that opportunities exist not only in the UK but also in other countries. A policy to de-risk pension liabilities around the globe can provide big benefits by reducing risk, improving corporate governance and drastically reducing the time taken and cost spent to manage pension plans, which seems to ever increase as pension legislation gets increasingly complex. Within Europe the possible introduction of Solvency II style thinking to pension plans is likely to increase companies’ interest in removing pensions risk from their corporate balance sheet. Companies should therefore keep aware of local market developments and where this may provide opportunities to de-risk pension plans at an attractive price.

Shaun Southern
Partner
LCP

Whilst the most effective way to de-risk differs by country, reflecting the different local legislation and pension markets, in almost all countries it is possible for companies to take steps to de-risk their pension plans.

Appendices

Ken Hardman
Partner
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At LCP we work on deals of all sizes, from ground-breaking structures for some of the UK's largest pension plans to launching a streamlined process to give smaller pension plans access to the market.

Buy-out and buy-in business written by insurers

		Total size of transactions (£m)					
Insurer	**Date of entry**	**Q1 2011**	**Q2 2011**	**Q3 2011**	**Q4 2011**	**Total**	**Market share 2011**
Legal & General	1986	23	218	31	1,190	1,461	28%
Aviva	May 2006	139	169	34	757	1,099	21%
Rothesay Life (Goldman Sachs)	July 2007	0	0	150	830	980	19%
Pension Insurance Corporation	October 2006	89	426	57	94	666	13%
MetLife	July 2007	30	278	116	200	625	12%
Prudential	1997	0	280	0	58	338	6%
Lucida	November 2007	0	0	0	45	45	1%
Total		**282**	**1,370**	**388**	**3,174**	**5,214**	

Source: Insurance company data and company press releases

Longevity swaps written by UK pension plans

Sponsoring company	Pension plan	Date	Liabilities covered (£m)	Provider
British Airways	Airways Pension Scheme	December 2011	1,300	Rothesay Life (Goldman Sachs)
Pilkington	Pilkington Superannuation Scheme	December 2011	1,000	Legal and General
Rolls-Royce	Rolls-Royce Pension Fund	November 2011	3,000	Deutsche Bank
ITV	ITV Pension Scheme	August 2011	1,700	Credit Suisse
Pall	Pall (UK) Pension Scheme	January 2011	70	J P Morgan
BMW	BMW (UK) Operations Pension Scheme	February 2010	3,000	Abbey Life (Deutsche Bank)
Local government	The Royal County of Berkshire Pension Fund	December 2009	750	Windsor Life (Swiss Re)
Babcock International	Babcock International Group Pension Scheme	December 2009	300	Credit Suisse
Babcock International	Rosyth Royal Dockyard Pension Scheme	September 2009	350	Credit Suisse
RSA Insurance Group[1]	RIGPS and SAL pension schemes	July 2009	1,900	Rothesay Life (Goldman Sachs)
Babcock International	Devonport Royal Dockyard Pension Scheme	June 2009	500	Credit Suisse
		Total	**13,870**	

[1]The longevity swap was also combined with an asset swap making the transaction effectively a synthetic pensioner buy-in.

Source: Insurance company data and company press releases

Pension buy-ins and buy-outs over £100 million announced since 2008

Name	Size (£m)	Sector	Insurer	Date	Type
RSA Insurance Group	1900	Insurance	Rothesay Life (Goldman Sachs)	July 2009	Synthetic pensioner buy-in
British Airways	1300	Aviation	Rothesay Life (Goldman Sachs)	July 2010	Synthetic pensioner buy-in
Turner and Newall	1100	Manufacturing	Legal & General	October 2011	Buy-out (PPF rescue)
Thorn	1100	Engineering	Pension Insurance Corporation	December 2008	Full buy-out
Cable & Wireless	1050	Communications	Prudential	September 2008	Pensioner buy-in
GlaxoSmithKline	900	Pharmaceutical	Prudential	November 2010	Collateralised pensioner buy-in
Uniq	830	Food Producer	Rothesay Life (Goldman Sachs)	December 2011	Buy-out (PPF rescue)

Pension buy-outs over £100 million announced since 2008 (cont'd)

Name	Size (£m)	Sector	Insurer	Date	Type
Rank	700	Gambling	Rothesay Life (Goldman Sachs)	February 2008	Full risk transfer
Cadbury	500	Food Producer	Pension Insurance Corporation	December 2009	Pensioner buy-in
MNOPF	500	Various	Lucida	September 2009	Collateralised pensioner buy-in
Delta	450	Engineering	Pension Insurance Corporation	June 2008	Pensioner buy-out
Powell Duffryn / PD Pension Plan	400	Engineering	Paternoster	March 2008	Full buy-out
CDC	370	Public	Rothesay Life (Goldman Sachs)	November 2009	Pensioner buy-in
Friends Provident	360	Financial Services	Aviva	April 2008	Pensioner buy-in
Alliance Boots	320	Pharmaceutical	Pension Insurance Corporation	June 2010	Full buy-out
Aggregate Industries	305	Mining	Pension Insurance Corporation	February 2010	Pensioner buy-in
Home Retail Group	280	Retail	Prudential	June 2011	Pensioner buy-in
BBA Aviation	270	Aviation	Legal & General	April 2008	Pensioner buy-in
TI Group / Smiths Group	250	Engineering	Paternoster	September 2008	Pensioner buy-in
TI Group / Smiths Group	250	Engineering	Legal & General	March 2008	Pensioner buy-in
Undisclosed	250	Media	Aviva	December 2011	Pensioner buy-in
Law Society	235	Legal	MetLife	June 2011	Full buy-out
Leyland DAF	225	Vehicle Manufacturing	Pension Insurance Corporation	January 2009	Full buy-out
Pensions Trust	225	Charities	Paternoster	July 2008	Pensioner buy-in
Undisclosed FTSE 250	220	Unknown	Legal & General	June 2010	Unknown
Undisclosed	220	Retail	Legal & General	March 2009	Pensioner buy-in
Undisclosed	185	Banking	Aviva	December 2010	Pensioner buy-in
M-Real Corporation	180	Paper Manufacturing	Legal & General	March 2008	Full buy-out
Undisclosed	170	Undisclosed	Pension Insurance Corporation	April 2011	Full buy-out
Morgan Crucible	160	Engineering	Lucida	March 2008	Pensioner buy-in
London Stock Exchange	158	Finance	Pension Insurance Corporation	May 2011	Pensioner buy-in
TI Group / Smiths Group	150	Engineering	Rothesay Life (Goldman Sachs)	September 2011	Pensioner buy-in
Meat & Livestock Commission	150	Food Producer	Aviva	June 2011	Pensioner buy-in
Dairy Crest	150	Food Producer	Legal & General	June 2009	Pensioner buy-in
Aon Pension Scheme	150	Financial Services	MetLife	June 2009	Pensioner buy-in
Dairy Crest	150	Food Producer	Legal & General	December 2008	Pensioner buy-in
Ofcom	150	Public	Legal & General	July 2008	Pensioner buy-in
Undisclosed	149	Property	MetLife	November 2011	Pensioner buy-in
Undisclosed	145	Unknown	Legal & General	January 2009	Pensioner buy-in
Denso	136	Automotive	Pension Insurance Corporation	September 2009	Full buy-out
Vivendi	130	Communications	MetLife	November 2008	Full buy-out
West Ferry Printers	130	Printing	Aviva	September 2008	Collateralised pensioner buy-in
Next	125	Retail	Aviva	August 2010	Pensioner buy-in
Undisclosed	111	Unknown	Aviva	December 2011	Pensioner buy-in
MNOPF	100	Various	Lucida	May 2010	Pensioner buy-in
Undisclosed	100	Retail	Aviva	March 2010	Pensioner buy-in
Undisclosed	100	Manufacturing	MetLife	January 2010	Pensioner buy-in

Source: Insurance company data, company press releases and member announcements

Glossary of terms

Bespoke longevity swap	A swap which is linked to the longevity experience of the actual pension plan membership. The counterparty will pay the additional pension payroll if the underlying members live longer than expected; the pension plan will pay the additional pension payroll if the underlying members die sooner than expected.
Bulk annuity	Describes a contract between a pension plan and an insurance company, whereby an insurance company insures some or all of the liabilities of the pension plan. Depending on whether the short-term intention is to transfer policies into the names of individual pension plan members, bulk annuity contracts are referred to as buy-outs or buy-ins.
Buy-in	The purchase of a bulk annuity contract with an insurance company as an investment to match some or all of a pension plan's liabilities, and therefore reduce risk. Crucially the liabilities remain in the pension plan and the trustees retain responsibility for them. Specific contractual terms differentiate it from an annuity purchase. Commonly a buy-in covers the pensioner liabilities as a pensioner buy-in but there have been several buy-ins of non-pensioner liabilities or a subset of pensioner liabilities.
Buy-out	The process whereby a pension plan's liabilities are transferred to an insurance company using a bulk annuity contract and the obligation for the pension plan to provide those benefits is ceased. Usually this covers the full liabilities of the pension plan as a full buy-out and is followed by the wind-up of the pension plan.
Buy-out market	A term to encompass the range of solutions available to transfer risk from a pension plan to another institution, usually an FSA regulated insurance company. Risk transfer is typically achieved through a bulk annuity contract (see buy-out and buy-in) or a longevity swap contract.
Closure	An action to restrict the future build-up of liabilities in a pension plan. It could be restricted to closing the pension plan to new members or be extended to stopping benefit accrual. Stopping benefit accrual usually means that current active members become deferred pensioners, sometimes retaining a link to future increases in their salary.
Collateral	Assets specifically set aside or earmarked to reimburse one party for the default of a counterparty (eg an insurance company or bank). Collateral is sometimes built into the structure of larger buy-in contracts and swaps to provide additional protection to the trustees and provider.
Collateralised buy-in	A buy-in annuity contract with a surrender value option available in defined circumstances (eg provider insolvency). This is normally supported by a designated ring-fenced pool of assets to provide the surrender value should it be exercised. The assets are normally long-dated corporate bonds.
Counterparty risk	The risk for a given party that the other party (eg an insurance company or bank) defaults on its obligations. Mechanisms such as posting collateral can sometimes be negotiated to reduce the potential impact of this risk.
Financial Services Compensation Scheme (FSCS)	A statutory compensation arrangement funded on a "pay-as-you-go" basis by an annual levy on the financial services industry. It is expected to provide broadly 90% compensation on annuity contracts in the event of an insurance company defaulting.
Full buy-out	A buy-out contract covering all known liabilities in a pension plan, usually followed by the pension plan winding-up.
Full risk transfer	A full buy-out transaction where the insurance company assumes immediate responsibility for all the risks borne by the pension plan – such as incorrect data risk, GMP equalisation risk and other legislative risks.
GMP equalisation	The process of adjusting pension plan benefits to allow for the inequality in the definition of Guaranteed Minimum Pensions (GMPs) between males and females. The practicalities of this can be complex.
Hedging	Purchasing assets that have similar characteristics to the pension plan's liabilities, so that if the value of the liabilities rises/falls this is matched by a similar rise/fall in the value of the assets.
Index-based longevity swap	A swap where the actual payout is linked to a standard population. For example, the counterparty may pay out to the pension plan if the longevity of the standard population improves faster than anticipated. Index-based swaps are flexible, but provide only partial longevity protection against actual pension plan experience.
In-specie asset transfer	The transfer of some or all of the pension plan's assets directly to the insurance company to pay the premium for the buy-in or buy-out contract. This can sometimes provide a saving compared to paying the premium in cash owing to the reduced transaction costs involved.

Liability Driven Investment (LDI)	A specialised investment (usually made up of cash and swaps) designed to have a similar cashflow profile to a pension plan's liabilities. So, if the value of the liabilities increases, the value of the investment also increases. This is a type of hedging.
Liability management	The process of taking active steps to manage the risk involved with a pension plan's liabilities. Practical examples include transfer value exercises, pension plan closure or conducting a trivial commutation exercise.
Longevity hedge	The purchase of an investment to remove the risk of pension plan members living longer than expected. The main way of hedging longevity risk, other than buying annuities, is to use a longevity swap.
Longevity swap	A tool to enable pension plans to transfer the risk of members living longer than expected to a third party (the counterparty), whilst retaining direct control of the assets. The two main types of longevity swap are a bespoke longevity swap and an index-based longevity swap.
Mono-line insurance company	An insurance company offering products within a single business line, such as bulk annuities.
Multi-line insurance company	An insurance company that writes business across a range of lines of business (eg investment management and other insurance products).
Partial buy-in / buy-out	A buy-in or buy-out covering only a proportion of a pension plan's liabilities. The most common type is a pensioner buy-in.
Pensioner buy-in	A buy-in which covers payments to current pensioners and their dependants.
Pricing basis	The basis used by insurance companies to price buy-ins or buy-outs. Contrast to reserving basis.
Profit share	A provision in a bulk annuity contact for the insurance company to make payments to the trustees, or to an agreed third party, if the experience under the contract is better than anticipated in the insurance company's pricing.
Progressive or staged risk transfer	A buy-out or buy-in transaction which is completed in several stages, often as part of a pre-determined premium payment plan based on asset performance. This allows risk to be transferred when the pension plan can afford to do so.
Reserving basis	The basis used by insurance companies to calculate the reserves they must hold. It will be based on prudent assumptions and will have regard to FSA rules. It will generally be much more prudent than the pricing basis.
Residual longevity risk	The risk of members living longer than expected that is not covered by an index-based longevity swap. The residual risk is due to differences between the pension plan membership and the index's standard population.
Solvency capital	The additional capital that an insurance company must set aside, in addition to the premium paid, when writing a buy-out or buy-in. This provides a buffer against adverse future experience.
Standard population	The underlying population used to determine the payouts under an index-based longevity swap – for example the population of England and Wales.
Swap	An agreement with a counterparty (often an investment bank) to 'swap' types of liability exposure. For example, under an inflation swap a pension plan pays the bank if inflation falls compared to expectations, but the bank pays the pension plan money if inflation rises. This hedges the pension plan's inflation risk.
Synthetic buy-in	A series of swap contracts to hedge longevity, investment and inflation risks such that the combined effect is similar to a traditional buy-in. The pension plan retains the assets held as collateral to support the swap contracts and so the exposure in the event of provider default is limited. The assets are normally long-dated government-backed securities. It is sometimes called a DIY buy-in.
Transfer value exercise	An exercise where deferred pensioners (and sometimes also active members) are given the opportunity to transfer their benefits out of the pension plan. An enhancement is often offered above the pension plan's standard transfer terms, either to the transfer value itself or as a cash payment outside the pension plan, to make it more attractive for members to transfer.
Trivial commutation exercise	An exercise to commute small pensions in the pension plan for a cash lump sum. This can both reduce risk and save on future administration costs.

Notes

LCP INSIGHT CLARITY ADVICE

LCP Pension Buy-ins, Buy-outs and Longevity Swaps 2012

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