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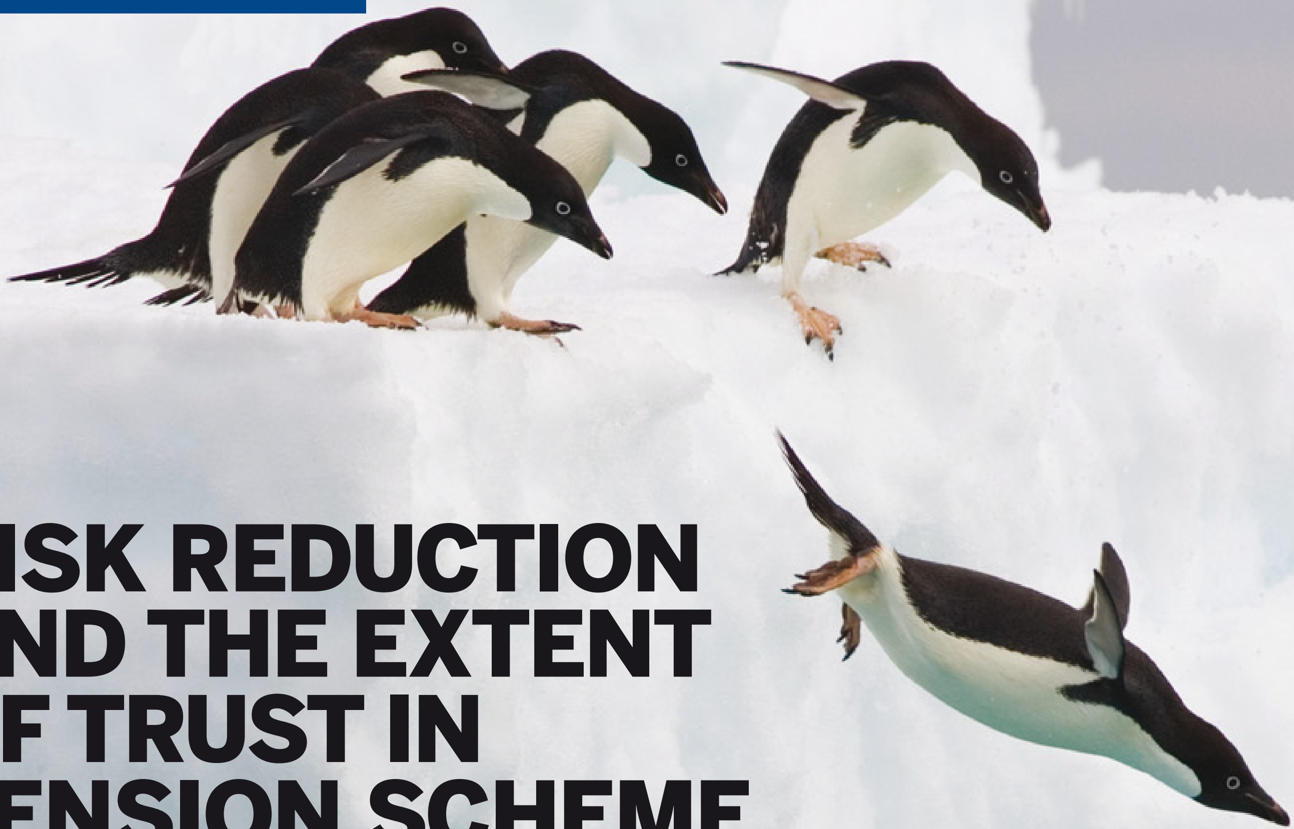

RISK REDUCTION AND THE EXTENT OF TRUST IN PENSION SCHEME ADVISORS AND PROVIDERS

In association with

PENSION INSURANCE CORPORATION

PENSION INSURANCE CORPORATION

Risks transferred, pensions insured

PIC specialises in innovative, bespoke bulk annuity transactions, offering superior client service to our policyholders and to the trustees and sponsors of UK defined benefit pension funds.

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The current de-risking landscape for schemes

The desire to de-risk schemes and move to a more sustainable and predictable footing for the future has never been greater.

But at the same time the appetite to de-risk is growing, scheme deficits have been increasing, meaning the affordability of such risk reduction can be challenging.

This supplement will present the results of exclusive research *Professional Pensions* has conducted in association with Pension Insurance Corporation and look at the current de-risking landscape among UK pension schemes.

It also looks at how two pension schemes conducted landmark de-risking transactions over the past 24 months – looking at how the Philips UK Pension Fund completed a £2.4bn buyout and also assessing how the Total UK Pension Plan executed a £1.6bn buy-in.

In addition to this, we have assembled a panel of some of the leading risk reduction advisers in the market, asking them for their outlook for the risk reduction market.

This supplement also looks at trust in institutional pensions and our research asks the extent to which trust is important when it comes to choosing and working with scheme advisers and providers as well as looking at what makes the most trustworthy firms worthy of that trust.

Following the research we conducted a webinar to discuss the issues raised and look at the extent to which we need to build pension scheme trust in advisers and providers.

Finally, earlier this year, Pension Insurance Corporation facilitated a lecture from David Pitt-Watson, the executive fellow of finance at the London Business School, where he asked whether the finance industry does a good job. We include our summary within this supplement.

We hope you find our research and supplement both useful and thought-provoking.

Jonathan Stapleton
Editor-in-chief, *Professional Pensions*

About Pension Insurance Corporation

Pension Insurance Corporation plc (PIC) provides tailored pension insurance buyouts and buy-ins to the trustees and sponsors of UK defined benefit pension funds. PIC brings safety and security to scheme members' benefits through innovative, bespoke insurance solutions, which include deferred premiums and the use of company assets as part payment. At year-end 2015 PIC had £16.6bn in assets and had insured 132,100 pension fund members. Clients include FTSE 100 companies, multinationals and the public sector. PIC is authorised by the Prudential Regulation Authority (PRA) and regulated by the Financial Conduct Authority and Prudential Regulation Authority (FRN 454345).

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One year – UK: £499; Europe: €725; Overseas: $815.
Make cheque payable to 'Incisive Financial Publishing' and send to:
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Qualifications and awards
Pensions Management Institute Retirement Provision Certificate (RPC): Jonathan Stapleton, Helen Morrissey. **SPP Trade Journalist of the Year:** 2011 and 2014, Jonathan Stapleton. **Towers Watson HR Publication of the Year Award:** 2010 and 2011, *Professional Pensions*. **State Street Data and Innovation Journalist of the Year 2015:** Michael Klimes. **Investment Association Trade Journalist of the Year 2015**: Jonathan Stapleton

Average net circulation for the period 1 July 2014 to 30 June 2015: 12,255. (7/06-6/07) ISSN-1743 3320

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Key views of the market and how it will evolve

Professional Pensions looks at the risk reduction marketplace and asks how it will evolve

The bulk annuities market in the UK has seen significant growth. Total liabilities of defined benefit (DB) schemes in the UK stand at over £2trn. Whilst £60bn of liabilities have been insured via buy-in or buyout since 2007, £25bn of this has been insured within the last two years, demonstrating the speed at which the sector is growing.

Recent press coverage highlights the vulnerable position of many of the UK's defined benefit (DB) pension schemes. The latest figures[1] from the PPF which covers 6,000 private sector pension schemes in the UK[2] and their 11 million members show that 5 out of 6 schemes are nursing a deficit. Scheme funding levels have generally weakened in recent years with QE and low gilt yields generally contributing to the problem. These problems have made front page news for British Steel and BHS.

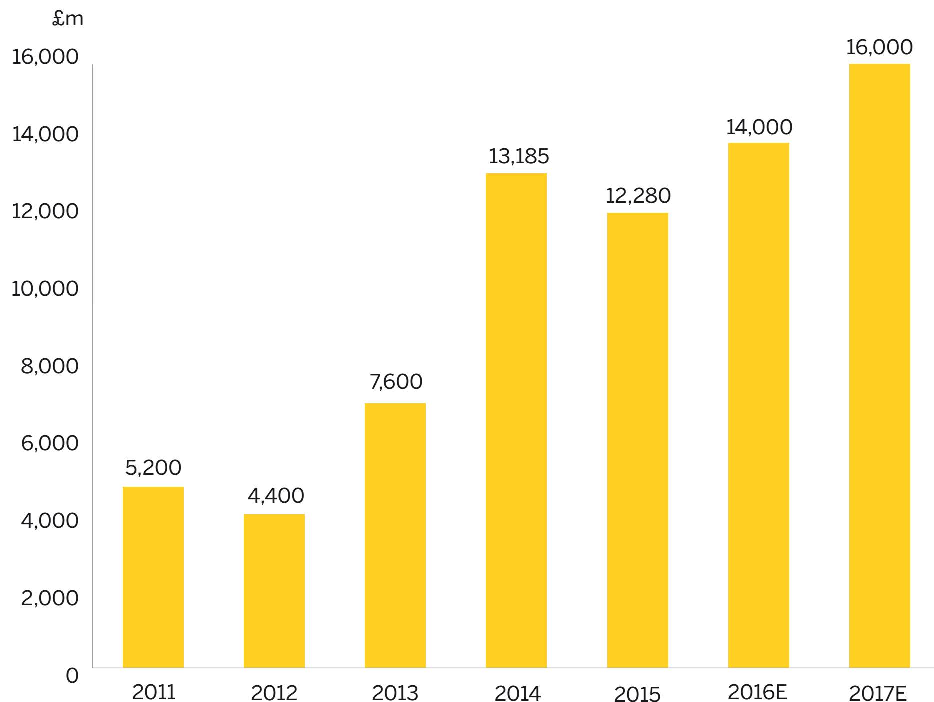
According to data from the Pension Protection Fund's (PPF) Purple Book, c.£250bn has been paid by UK corporate sponsors to reduce deficits in DB pension schemes since 2009[3], yet deficits remain as wide as they have ever been

And this is a very long term issue – total DB-associated pension payments are unlikely to reach a peak for more than 20 years and even in 40 years, the burden of payments is expected to be just as great as it is today[4].

Due to their inherent risks, pension schemes are increasingly looking to the bulk annuity market to offer a definitive solution.

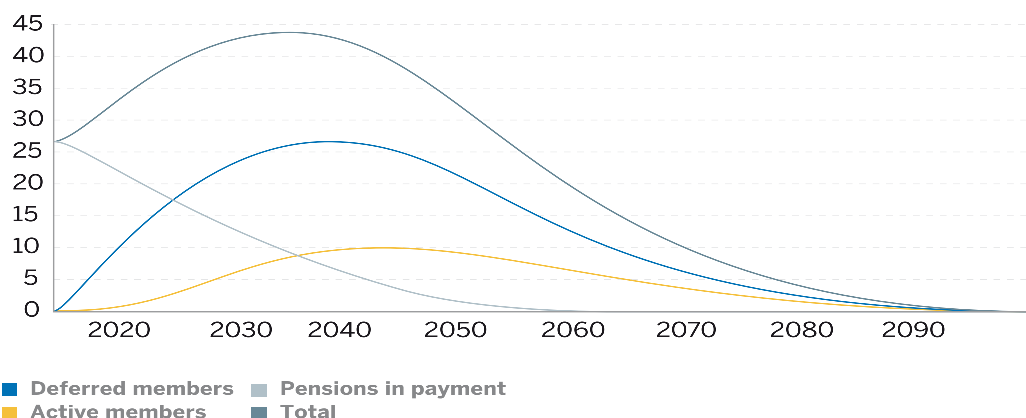
The past two years have seen over £10bn per annum of pension fund liabilities secured through insurance, with Pension Insurance Corporation

Uses of capital – Growth: DB pension de-risking UK bulk annuity sales, 2011–2017E



Data from: LCP Pension De-risking 2015 and 2016 reports, Hymans Robertson, RBC Capital Markets estimates
Source: RBC Capital Markets, European Insurance – 2016 Outlook, December 2015

A long term opportunity: Constant price cash payments across all DB schemes (£ billions, constant 2014 prices)



"Total DB-associated pension payments are unlikely to reach a peak for more than 20 years. Even in 40 years, the burden of payments will probably be just as great as it is today."

Source: Who carries the risk?
Published by Fathom Consulting with support from Pension Insurance Corporation, December 2014

a long term leader in the market. Putting the amount in context, this is only approximately 0.5% of the UK's total defined benefit pension fund liabilities.

It is not implausible that there will be an increase, even if record low gilt yields over the past year have led some pension fund trustees to review their positions. However, those pension funds with a long-term strategy which includes aligning assets and liabilities as well as putting the right structures and processes in place to facilitate a buyout, can still transact regardless of market changes.

Indeed, pension schemes which held gilts have been able to use them to de-risk very profitably over the past five years. Around £500bn of gilts and fixed income assets are held by schemes and the transition of these to annuities a logical next step for many pension plans.

PENSION SCHEME DEFICITS

Regulation: Solvency II and other areas of relevance

The European Union has developed a new solvency framework for insurance companies, known as Solvency II. The initial Solvency II Directive was formally approved by the Economic and Financial Affairs Council in 2009 and has progressed through a series of formal consultations and updates before being formally implemented in January 2016.

"Due to their inherent risks, pension schemes are increasingly looking to the bulk annuity market to offer a definitive solution"

Solvency II increases the security of pension benefits that have been insured via a buy-in or buyout and brings greater transparency to the insurance industry, with regards to the resilience of an insurance company to an economic shock.

Under Solvency II, levels of minimum capital required by insurance companies have generally been increased compared to those called for under Solvency I. The regulation requires insurers to calculate capital requirements based on the specific risks that they underwrite, seeking to ensure that after a stress event, insurers will have sufficient assets to transfer their business to another insurance company, thereby allowing for continuation of protection for policyholders.

The regulation, based on the concept of three pillars; minimum capital requirements, supervisory review of firms' assessments or risk and enhanced disclosure requirements has compelled insurance companies to change their models, processes and systems in a fundamental way. The concepts of the three pillars were all present to a greater or lesser extend under Solvency I.

The UK insurance industry in general has been better placed than its European counterparts to implement Solvency II due to the similarity of the previous risk based regulatory system operated by the PRA (ICAS regime) as an enhancement to the basic requirements of Solvency I.

The Financial Services Compensation Scheme (FSCS), the guarantor of policyholder

1 The Purple Book 2015: Pension Protection Fund (2015)
2PPF does not pay 100% of benefits to members of private sector pension schemes
3Data from the PPF's Purple Book (2009 onwards)
4'Who carries the risk?' Published by Fathom Consulting with support from Pension Insurance Corporation (December 2014)

benefits in the unlikely event of insurance company insolvency, increased its protection for annuities to 100% of the insured amount in 2015. Combined with the increase in security brought about by Solvency II, bulk annuities can now be considered an even more secure product than before.

Longevity reinsurance

Longevity risk is one of the major factors facing trustees. If pensioners were to live on average one year longer than assumed, then c.£60bn could be added to the liabilities of UK private sector defined benefit pension funds. As the sector grows, so does the demand for off-setting longevity risk via the global reinsurance market. Reinsurers are generally more natural holders of the risk because of their offsetting exposure to mortality risk and insurers often seek this security following a buy-in or buyout transaction.

Solvency II has also been a driver in this increased demand. Under the new regime, insurers signing buy-in/buyout deals have increasingly been entering into simultaneous reinsurance transactions to transfer the longevity risk from the annuities to a third party. Insurers have found that transferring longevity risk of a bulk annuity to a reinsurer (at a cost) is more efficient than retaining the risk and holding the associated capital to support the risk. As market capacity grows, it is less likely that providers will bear all of the risk from transactions themselves.

> **"If pensioners were to live on average one year longer than assumed, then c£60bn could be added to the liabilities of UK private sector defined benefit pension funds"**

Size of buy-in and buyout deals

2015/16 has seen an increase in the overall buy-in/buyout deal size, but a fall in the number of completed deals. There were more full scheme buyouts in Q4 2015, reflecting a move by some sponsors to secure pricing under the Solvency I model, fearing price rises on the introduction of Solvency II.

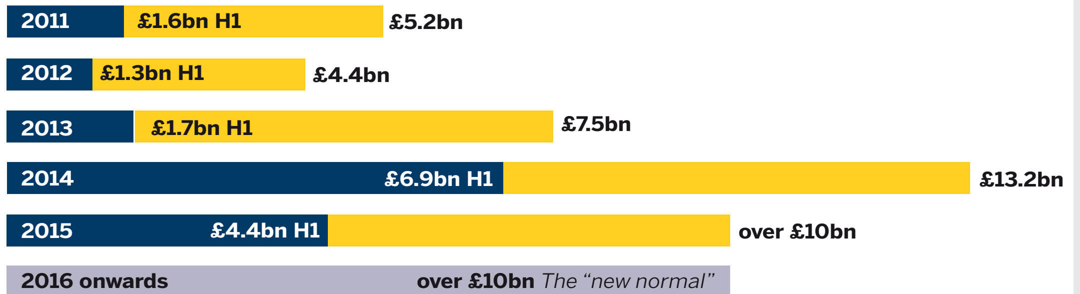
Over the past two years, large transactions have dominated the bulk annuities sector. Almost half of the £25bn transactions have been for £1bn+ deals with the number of buy-ins and buyouts under £100m reducing as some insurers chose to focus on larger transactions. Smaller contracts are still very significant to insurers illustrated by the fact that 49% of pension schemes below £100m have an ultimate target to buyout due to the disproportionally high costs of running a scheme versus 8% of £1bn+ schemes which are focused on self-sufficiency .

Around 150 transactions are written each year for less than £100m and this active area of the market is driving innovation to deliver attractive solutions for these smaller schemes. The number of longevity risk transactions is unlikely to grow amongst small schemes due to the disproportionate resource required to put them in place and then monitor them as their understanding of risks and awareness of risk settlement solutions increases.

Competition

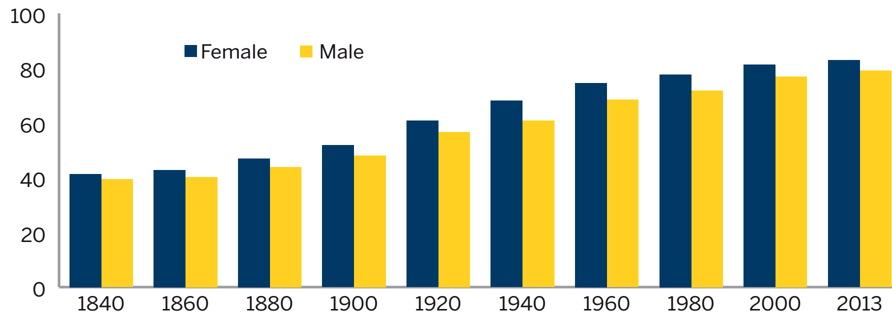
Increasing demand from pension schemes looking to transfer their risks has made the bulk annuities sector an attractive proposition for providers looking to join the market. A number of organisations have attempted to enter the sector with varying degrees of success over the past ten years. Successful market entry requires capabilities in mortality prediction, investment and operational efficiency. Administration capability is essential due to the often long and complex transition process which involves processing a significant amount of data.

For schemes and sponsoring employers, the emergence of new market entrants is a good thing; increasing competition and supporting innovation in the sector. Price tension alongside the increase in the availability of capital in the market helps schemes to achieve



Source: LCP pensions de-risking 2015 report

Period life expectancy at birth, in England & Wales, by decade and gender



Source: Data from the Human Mortality Database

attractive pricing levels from insurers.

NEW WAYS OF SLICING RISK

Medical underwriting

By the beginning of 2016, the medical underwriting bulk annuities market (MUBA) had reached over £6bn in 1bn from its inception in 2013. Top-slicing (where only the highest liability individuals are insured), potentially skew a scheme's overall risk profile and represent a significant concentration of longevity risk.

The process of gathering medical and lifestyle information for individual members can provide savings. Pricing levels have previously been competitive due to the desire of specialist insurers to grow this area and establish their market position, however the merger of Just Retirement and Partnership Assurance to form the JRP Group in April 2016, has reduced competition in the market.

The two companies have been responsible for the vast majority of medically-underwritten deals completed to date. Although Legal & General and Aviva are also engaged they enter into transactions on a relatively selective basis and have tended to focus on larger deals.

Market monitoring

Consultancies are increasingly encouraging trustees to monitor the market, tracking the price of various forms of pension scheme risk transfer index and allowing them to act when pricing is attractive. More frequent pricing feeds are available across the market which allows sponsors to identify to right moment to approach providers.

> **"The first half of the year has been dominated by pensioner buy-ins. In the short term, there is likely to be the continuation of requests to secure pensioners as part of ongoing de-risking initiatives"**

Although schemes can match their liabilities through a bond or sophisticated LDI mandate, the matching is imperfect due to compromises on the design of the portfolio, leaving the interest rate and inflation matching as inaccurate. Neither does it allow for the fundamental uncertainty over life expectancy and therefore the liability profile.

By monitoring the relative levels of gilts and buy-in pricing, the scheme has a better chance of capturing opportunities arising from volatility in different markets. The volatile swap and bond markets have affected perceived transaction affordability in Q1-Q2 2016, but they do offer strong pricing opportunities if moves are timed well. Moving at the right time can mean the difference between making a buy-in/buyout transaction being affordable or not.

Conclusion

Despite the challenges brought by the implementation of Solvency II, the growth of the bulk annuities sector has continued in 2016. The new regulations have fostered innovation in the bulk annuity space as providers find new ways to remain competitive with the framework.

The first half of the year has been dominated by pensioner buy-ins. In the short term, there is likely to be the continuation of requests to secure pensioners as part of ongoing de-risking initiatives.

Market volatility and low yields seen in the first half of 2016 has led to many scheme funding levels showing no sign of improvement despite following deficit funding plans.

Once market conditions improve, it is likely that there will be an increased demand for full scheme buyouts as an enabler of wider corporate activities (M&A, demergers, etc.). Coupled with the number of new market entrants and the additional capacity in the sector, it is likely to be another record-breaking year for the bulk annuities market.

Risk reduction and the extent of trust in advisers and providers

Jonathan Stapleton takes a look at the results of *Professional Pensions*' survey into risk reduction and trust in scheme advisers and providers

AT A GLANCE

- 121 UK trustees and pension professionals took part in the poll
- 60% of those surveyed expect to reduce risk over the coming 24 months
- Trust is vitally important when it comes to choosing advisers and providers to schemes

In order to gauge opinions of both de-risking over the coming year and assess the level of trust in the institutional pensions market, *Professional Pensions* conducted a research study in association with Pension Insurance Corporation (PIC) in April this year.

Some 121 UK trustees and pension professionals took part in the survey. Around half (49.6%) of respondents described themselves as trustees, 19% were pension scheme managers and 9% were finance directors. The remainder of respondents' occupations (24%) included consultants and advisers as well as those with other scheme roles.

Some 42% of respondents came from DB schemes that were closed to future accrual, 37% came from schemes closed to new members and 13% came from schemes that were still open to new members. The remaining 8% came from a range of hybrid schemes and schemes with both open and closed sections.

We received responses across a whole spectrum of schemes in terms of size of their technical provisions, the scheme specific funding standard which pension funds must target.

Just over a quarter (23%)

of those who responded to the survey had technical provisions of more than £1bn; a further 26% of schemes had technical provisions of between £250m and £1bn; and 13% had provisions of between £100m and £250m. A further 38% had technical provisions of up to £100m.

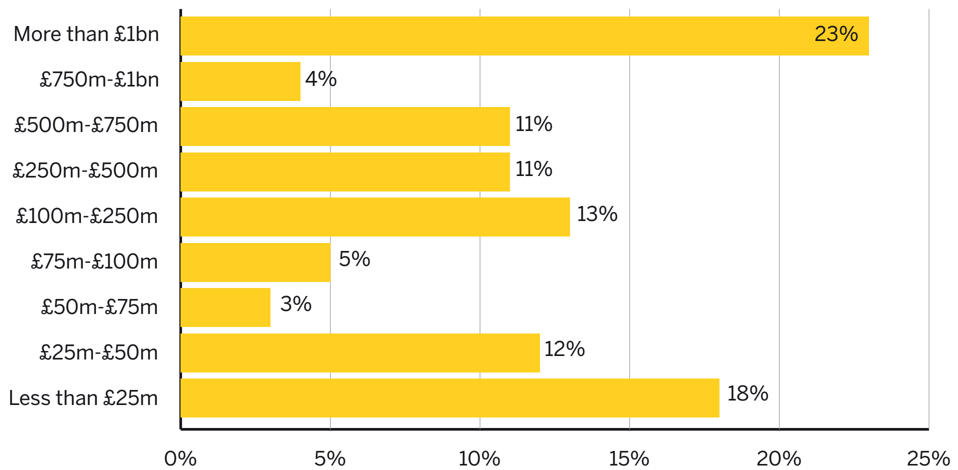
Of those schemes with technical provisions between £250m and £1bn, 42% (13 respondents) had provisions of between £250m and £500m; 42% (13 respondents) had technical provisions of between £500m and £750m; and 16% (5 respondents) had provisions of between £750m and £1bn.

And, of those schemes with technical provisions of up to £100m, 49% (22 respondents) had provisions of less than £25m; 31% (14 respondents) had technical provisions of between £25m and £50m; 7% (3 respondents) had provisions of between £50m and £75m and 13% (6 respondents) had provisions of between £75m and £100m.

23%

Respondents who had technical provision of more than £1bn

What are the technical provisions of your scheme?



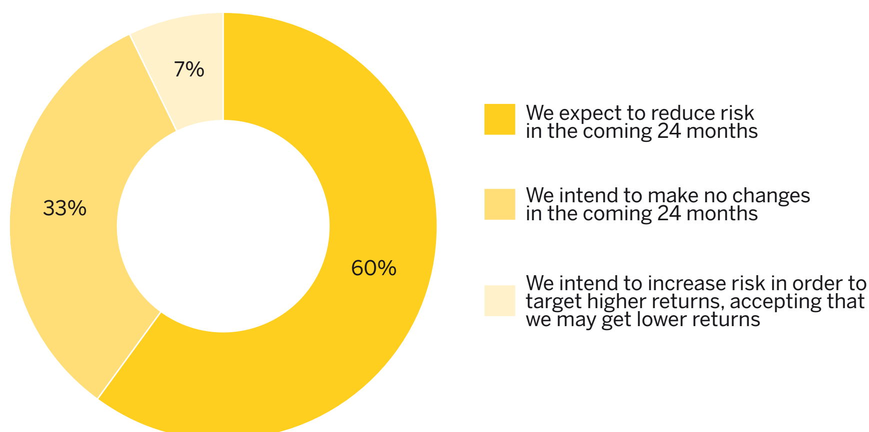
RISK REDUCTION

The first part of our research looked at risk reduction. According to our research, some 60% of respondents said they expected their scheme to reduce risk over the coming 24 months; and a further 33% said they intended to make no changes over the next two years. Some 7% of respondents, however, said they intended to increase risk in order to target higher returns, accepting they might get lower returns.

However, the survey found willingness to de-risk changed markedly with scheme size – with smaller schemes less likely to derisk over the coming 24 months.

Among those schemes with technical provisions of up to 100m, just 40% expected to de-risk over the coming 24 months – with 49% of respondents from schemes in this size range saying they planned to make no changes and 11% saying they would increase risk.

What is your scheme's current position with regards to de-risking ?



Of those schemes with technical provisions of £100m to £250m, 69% of respondents expected to reduce risk in the coming 24 months, 25% intended to make no change and 6% intended to increase risk.

This was roughly the same among schemes with technical provisions of between £250m and £1bn – where 68% of respondents said they expected their scheme to de-risk over the next two years against 29% who expected to make no change and just 3% that expected to increase risk.

Large schemes – those with technical provisions in excess of £1bn – were most likely to reduce risk over the coming 24 months. Some 79% of these respondents said they expected to de-risk within the next two years against only 18% that said their scheme would make no change and 3% who said their scheme would increase risk in order to target higher returns.

We then asked those respondents who said their scheme was expecting to reduce risk over the coming two years about how far their scheme had already gone towards implementing a range of risk reduction strategies – including longevity management exercises; de-risking assets; liability exercises, such as Pension Increase Exchanges (PIEs) and Enhanced Transfer Values (ETVs); as well as buyouts and buy-ins.

> **"Among those respondents expecting to de-risk over the coming two years, 50% said their scheme had increased the proportion of close matching assets"**

Matching assets

Of the various options open to them, the most implemented option among respondents' schemes was to increase the proportion of assets held in close matching assets such as gilts and bonds.

Among those respondents expecting to de-risk over the coming two years, 50% said their scheme had increased the proportion of close matching assets. A further 27% said they were currently implementing such a shift and 8% said they were planning to implement such a strategy.

But, while this option was the most implemented across all scheme sizes, smaller schemes had made less progress towards this goal than their larger peers – with just 33% of respondents from schemes with technical provisions of less than £100m saying their scheme had increased the proportion of close matching assets compared to 45% of respondents from schemes with technical provisions between £100m and £250m, 52% of respondents from schemes with provisions of £250m to £1bn and 64% of respondents in schemes with technical provisions in excess of £1bn.

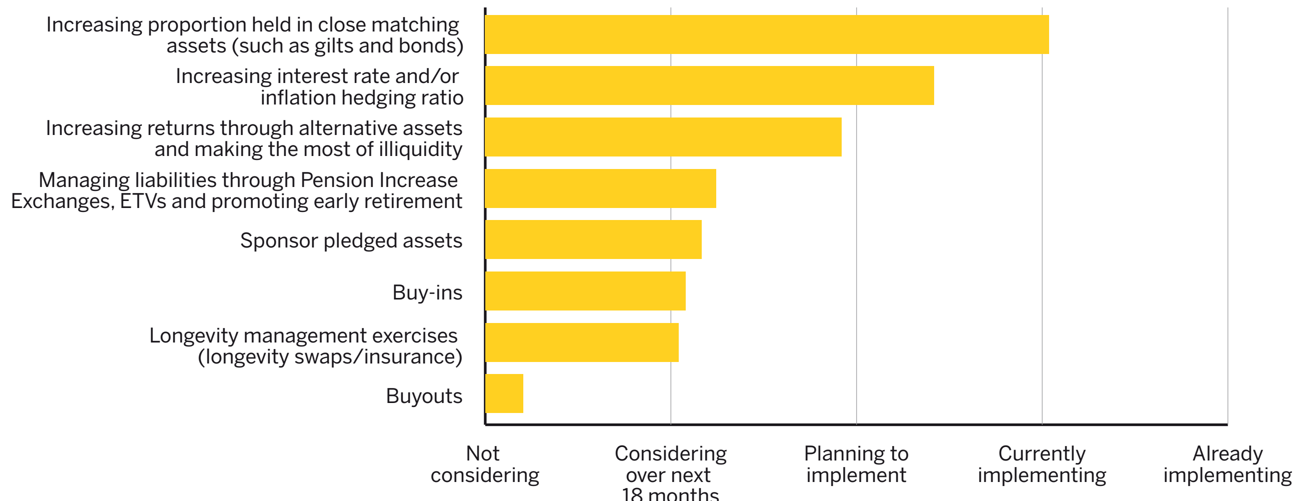
Hedging inflation and interest rate risk

The next most implemented risk reduction option among respondents' schemes was increasing their interest rate and/or inflation hedging ratio.

Among those respondents expecting to de-risk over the coming two years, 24% said their scheme had increased these hedging ratios. A further 34% said they were currently implementing such an increase and 14% said they were planning such a rise in hedging.

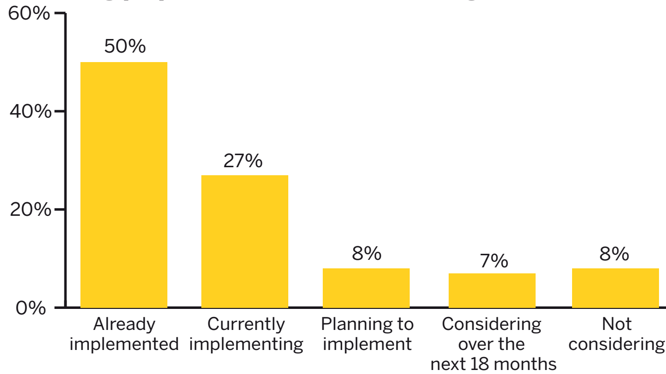
Once again, larger schemes were more advanced with implementing this option than smaller schemes – with just 6% of respondents from schemes

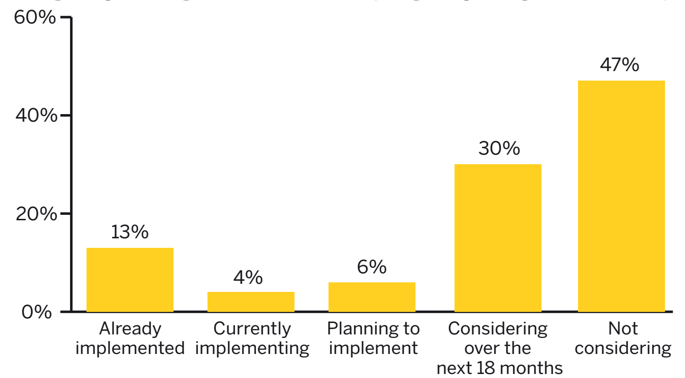
How far has your scheme gone towards implementing the following risk reduction strategies?

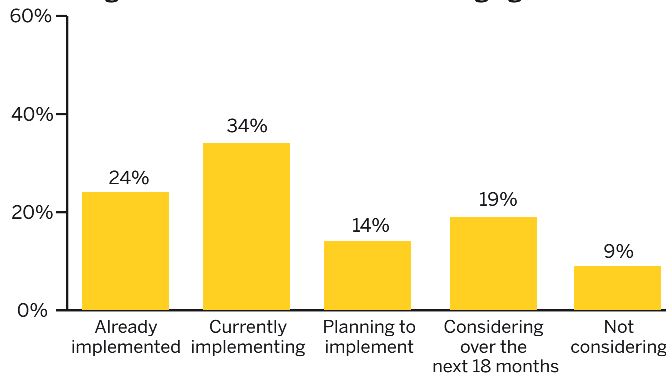


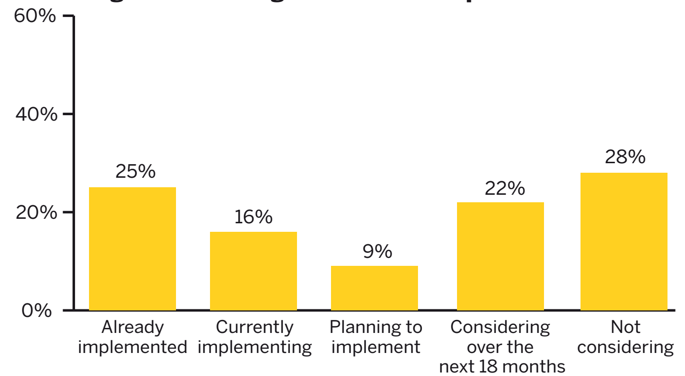
Note: Answers from those respondents expecting to de-risk over the coming two years

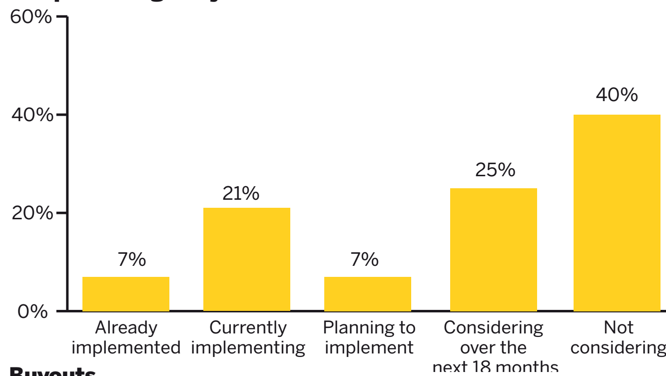
How far has your scheme gone towards implementing the following risk reduction strategies?

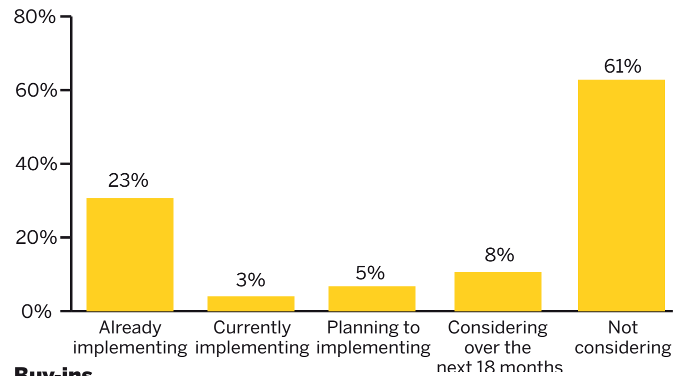


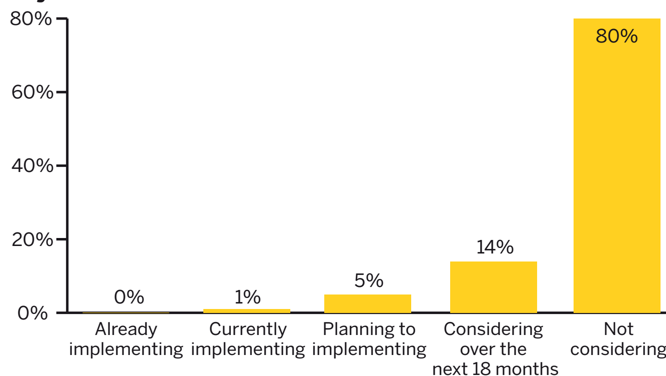


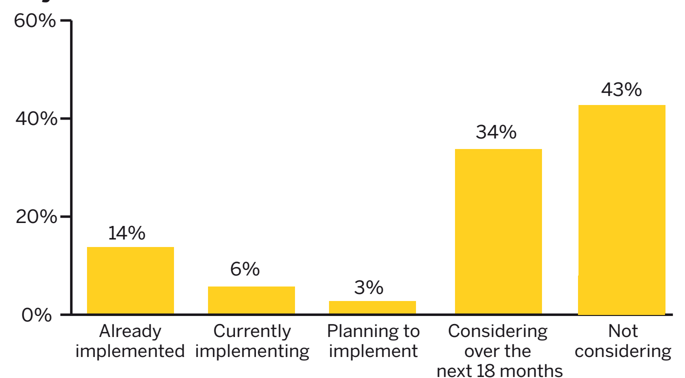












Note: Answers from those respondents expecting to de-risk over the coming two years

0%

Respondents from schemes with technical provisions of less than £100m planning to implement a strategy to increase returns through alternatives

with technical provisions of less than £100m saying their scheme had increased hedging compared to 18% of respondents from schemes with technical provisions between £100m and £250m, 28% of respondents from schemes with provisions of £250m to £1bn and 36% of respondents in schemes with technical provisions in excess of £1bn.

Increasing returns

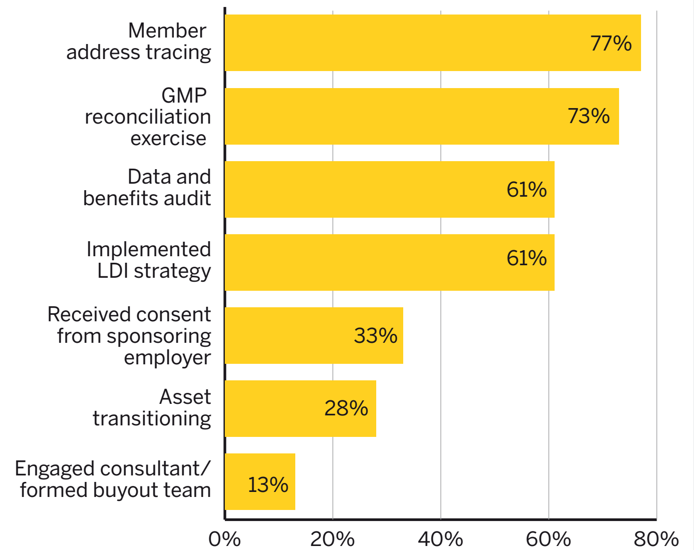
Many schemes were also looking at increasing returns through investment in alternative assets and making the most of the illiquidity premium.

Among those respondents expecting to de-risk over the coming two years, 25% said their scheme had implemented such a shift towards alternatives or more illiquid assets. A further 16% said they were currently implementing such a strategy and 9% were planning to implement such a strategy.

There was a stark difference here between the approach of smaller and larger schemes.

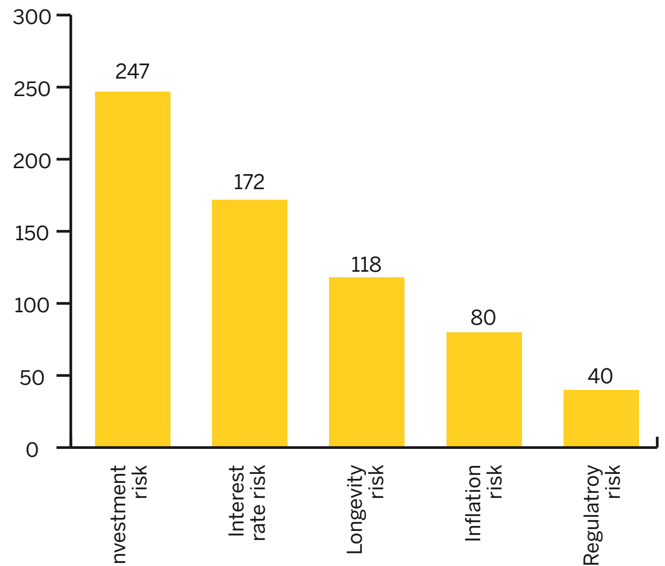
None of the respondents from schemes with technical provisions of less than £100m said their schemes had implemented a strategy to increase returns through alternatives, nor were any currently implementing such a strategy. Some 9% of respondents from schemes with technical provisions between £100m and £250m had implemented a more alternatives-based investment strategy along with 19% of respondents from schemes with provisions of £250m to £1bn and over half (57%) of respondents in schemes with technical provisions in excess of £1bn.

Which preparatory steps has your scheme taken to help achieve its long term de-risking objectives?



Note: Answers from those respondents expecting to de-risk over the coming two years

Which are the biggest risks facing your pension scheme curently?



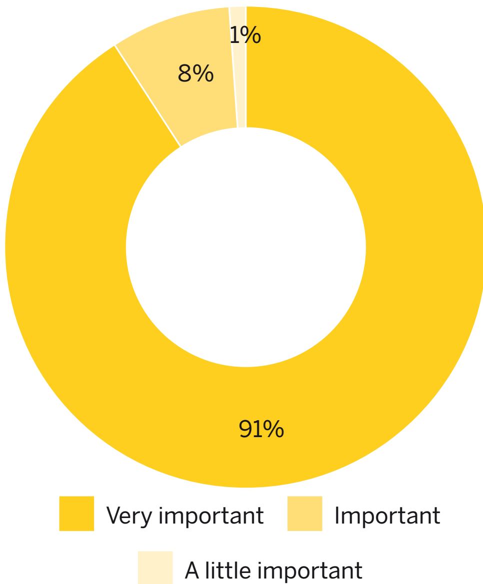
Note: All respondents

Managing liabilities

Managing liabilities through PIEs, ETVs and promoting early retirement were less popular options for respondents as a whole. Among those respondents expecting to de-risk over the coming two years, just 7% said their scheme had used these sorts of exercises to reduce risk. But this could change rapidly in the future as a further 21% said they were currently implementing such a strategy and 7% said they were planning to conduct such an exercise.

Once again, larger schemes

How important is trust when it comes to choosing and working with advisers and providers?



tended to be more advanced in their implementation of these sorts of exercises than their smaller peers.

Some 7% of respondents from schemes with technical provisions of less than £100m said they had implemented such exercises compared to no respondents from schemes with technical provisions between £100m and £250m, 11% of respondents from schemes with provisions of £250m to £1bn and 14% of respondents in schemes with technical provisions in excess of £1bn.

Sponsor pledged assets

Sponsor pledged assets were not a commonly used option among respondents to the survey but a significant minority had used these as a way of reducing risk.

Among those respondents expecting to de-risk over the coming two years, 23% said their scheme had used such a strategy.

A further 3% said they were currently implementing sponsor pledged assets and 5% said they were planning such a strategy.

The use of sponsor pledged assets was, once again, more prevalent among larger schemes – with some 26% of schemes with technical provisions in excess of £1bn, 25% of schemes with technical provisions of between £250m and £1bn and 27% of schemes with provisions of between £100m and £250m using such options, compared to just 13% of schemes with provisions of less than £100m.

> **"Among those respondents expecting to de-risk over the coming two years, 14% said their scheme had implemented a buy-in"**

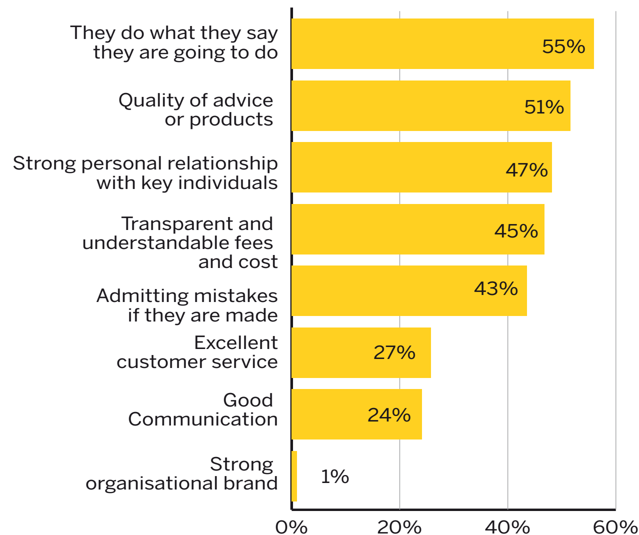
Buy-ins

Buy-ins were a reasonably popular form of risk reduction among respondents.

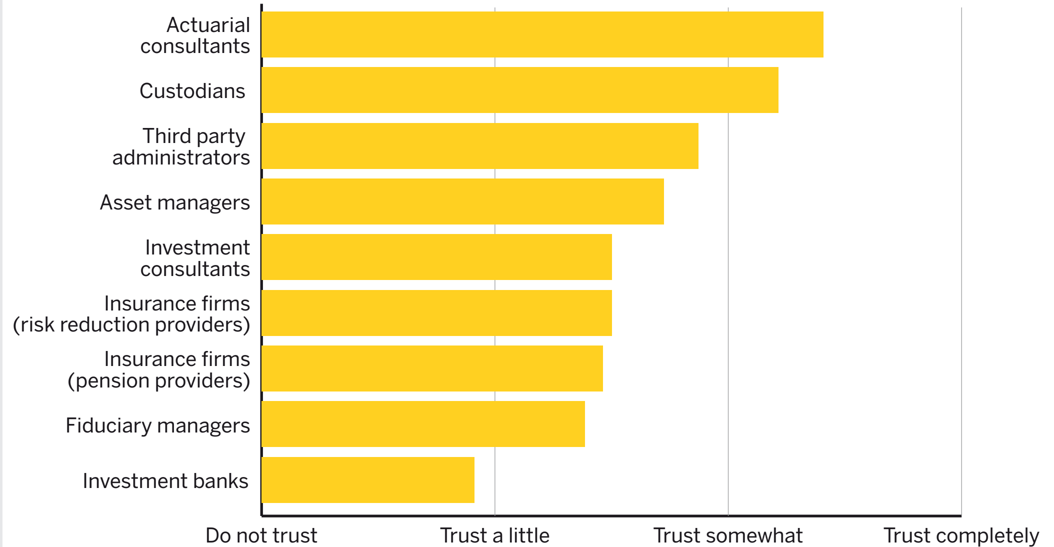
Among those respondents expecting to de-risk over the coming two years, 14% said their scheme had implemented a buy-in. A further 6% said they were currently implementing a buy-in, 3% said they were already planning a buy-in, and 34% said they would consider such a move over the next 18 months.

Buy-ins had roughly equal popularity among smaller to medium sized schemes but were significantly more popular

What makes the most trustworthy firms worthy of that trust?



Note: Respondents could choose a maximum of three options



among the largest schemes. Some 12% of respondents from schemes with technical provisions of less than £100m said their scheme had implemented a buy-in compared to 9% of schemes with technical provisions between £100m and £250m, 10% of respondents from schemes with provisions of £250m to £1bn and 21% of respondents in schemes with technical provisions in excess of £1bn.

Longevity management

Among those respondents expecting to de-risk over the coming two years, just 13% had conducted longevity management exercises such as longevity swaps or insurance. A further 4% said they were currently implementing a longevity management exercise, 6% said they were planning one, and 30% said they were likely to consider such a move over the next 18 months.

Once again, longevity management exercises had significantly more popularity among larger schemes – with no respondents from schemes with technical provisions of less than £100m saying their scheme had implemented such an exercise, compared to 18% of schemes with technical provisions between £100m and £250m, 10% of respondents from schemes with provisions of £250m to £1bn and 24% of respondents in schemes with technical provisions in excess of £1bn.

Buyouts

While, unsurprisingly perhaps, there were no respondents to the survey that said their scheme had conducted a buyout, there were a number of schemes implementing or considering such an option.

Among those respondents expecting to de-risk over the coming two years, 1% said they were currently implementing a buyout, 5% said they were already planning to implement one and 14% said they were considering such a move over the next 18 months.

Respondents from smaller schemes tended to find the buyout option more appealing on average than larger ones – with 33% of schemes with technical provisions of less than £100m either currently

Research methodology

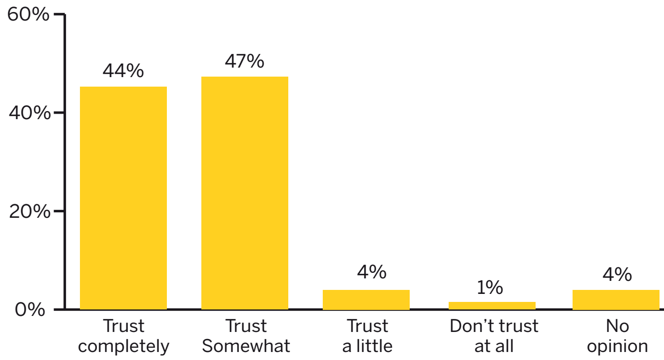
This report details the findings from *Professional Pensions* research conducted in April 2016 in association with Pension Insurance Corporation.

The overall aim of this research was to gauge opinions of both de-risking over the coming year and trust in the institutional pensions market. Interviews were conducted among a representative sample of 121 trustees and pension professionals in the UK. All interviews were carried out online using Computer-Assisted Web Interviewing (CAWI).

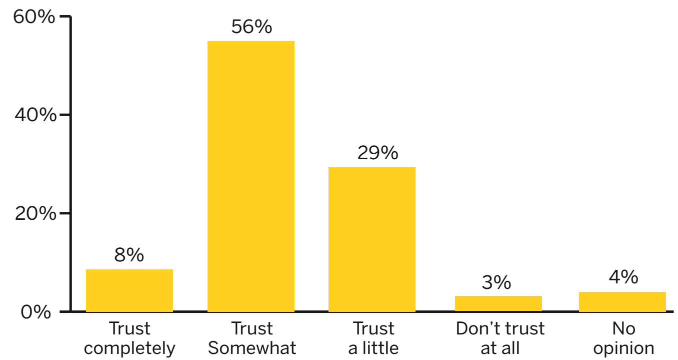
Overall, some 50% of respondents described themselves as trustees, 19% were pension scheme managers and 7% were finance directors. The remainder of respondents' occupations (24%) included consultants and advisers as well as those with other scheme roles.

To what extent do you trust the following organisations?

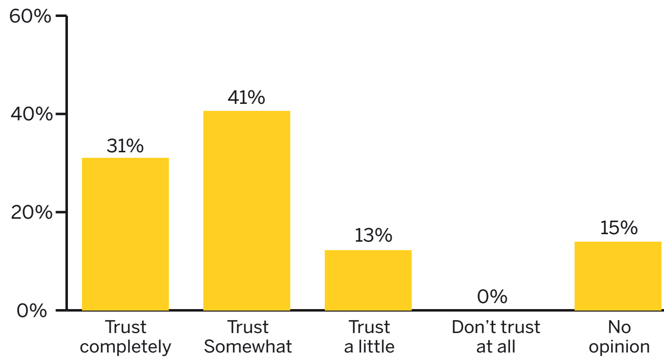
Actuarial consultants



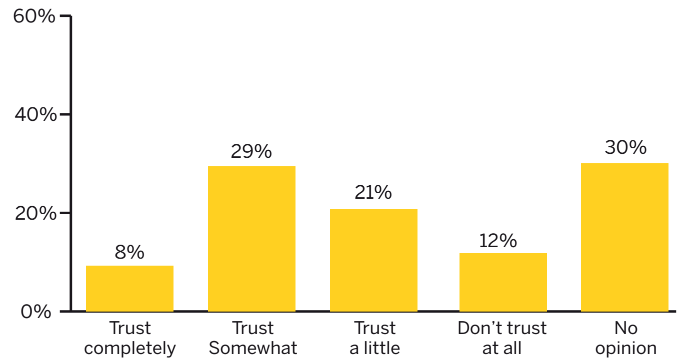
Asset managers



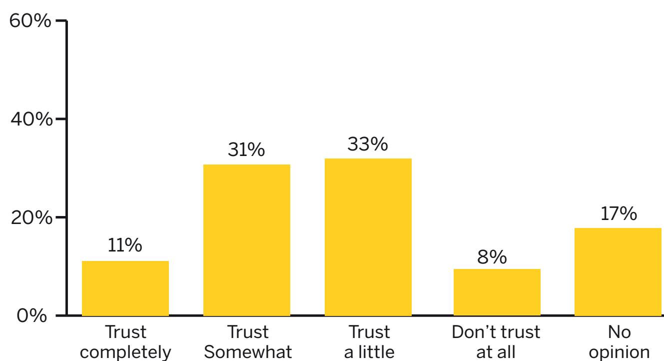
Custodians



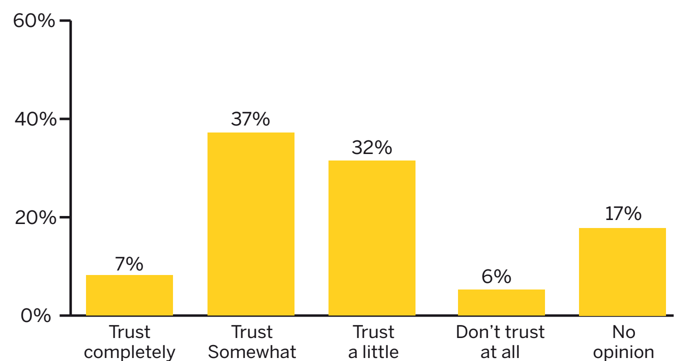
Fiduciary managers



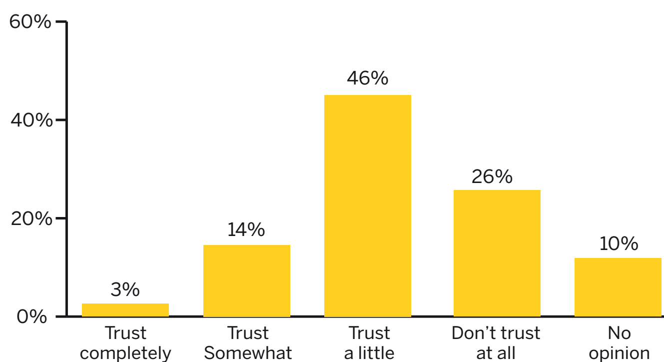
Insurance firms (pension providers)



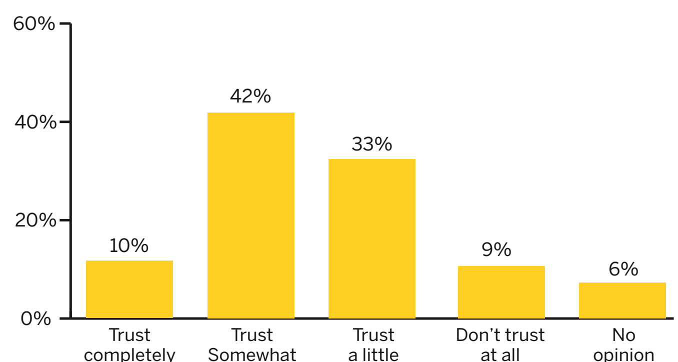
Insurance firms (risk reduction providers)



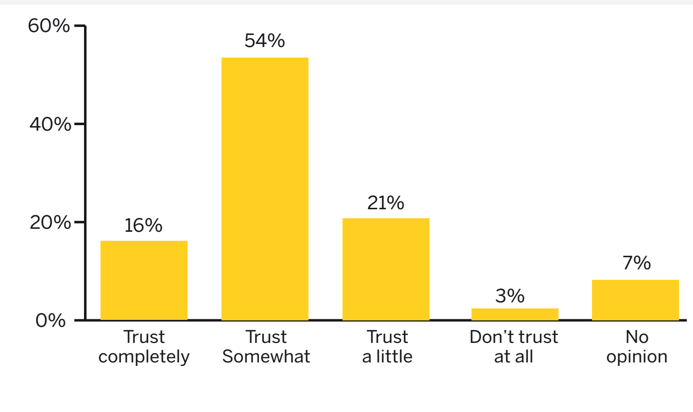
Investment banks



Investment consultants



To what extent do you trust TPAs?



implementing, planning to implement or considering such a move. This compares to 18% of schemes with technical provisions of between £100m and £250m, 15% of schemes with provisions of £250m to £1bn and 17% of respondents in schemes with technical provisions in excess of £1bn.

Preparatory steps

We then asked those respondents who said their scheme was expecting to reduce risk over the coming two years about what preparatory steps, if any, their scheme had taken to help achieve its long-term de-risking objectives.

Some 77% of respondents said their scheme conducted a member address tracing exercise, 73% had conducted a GMP reconciliation exercise, 61% had done a data and benefit audit and 61% had implemented a liability-driven investment strategy.

In addition, 33% had received consent from their sponsoring employer, 28% had conducted some asset transitioning and 13% had engaged a consultant or formed a buyout team.

Yet, as you might imagine, the level of preparedness varied significantly between schemes of different sizes – with the very smallest schemes generally being less well prepared than their larger counterparts.

Just 69% of respondents from schemes with technical provisions of less than £100m had conducted a member address tracing exercise, compared to 80% of schemes with technical provisions between £100m and £250m, 76% of respondents from schemes with provisions of £250m to £1bn and 82% of respondents in schemes with technical provisions in excess of £1bn.

There was a similar pattern elsewhere, with just 56% of respondents from schemes with technical provisions of less than £100m having conducted GMP reconciliation exercises, compared to 70% of schemes with technical provisions between £100m and £250m, 81% of schemes with provisions of £250m to £1bn and 77% of schemes with technical provisions in excess of £1bn.

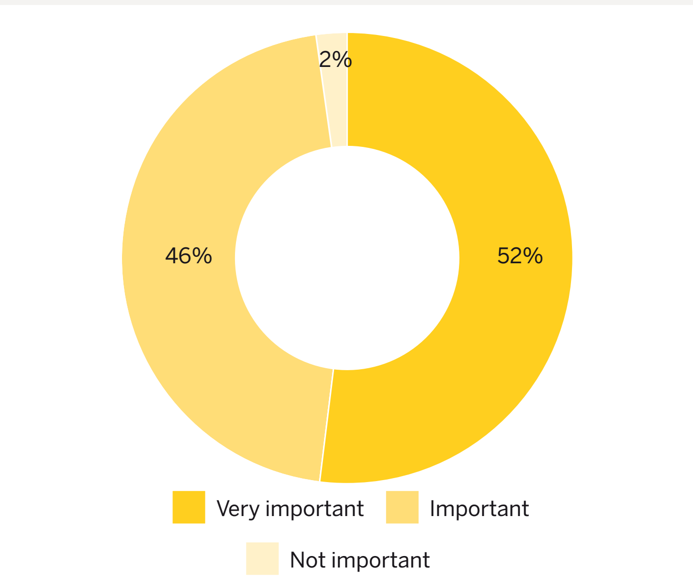
And just 50% of respondents from schemes with technical provisions of less than £100m had completed a data and benefit audit, compared to 60% of schemes with technical provisions between £100m and £250m, 67% of respondents from schemes with provisions of £250m to £1bn and 64% of respondents in schemes with technical provisions in excess of £1bn.

The biggest risks facing schemes

The final question we asked

"Just 50% of respondents from schemes with technical provisions of less than £100m had completed a data and benefit audit"

How important is policyholder and member services when it comes to working with advisers and providers?



respondents was about what they felt were the biggest risks facing their scheme currently – asking them to select up to three from a list of options.

Investment risk ranked highest, with a weighted score of 247; followed by interest rate risk, with a score of 172; longevity risk, with a score of 118; inflation risk, with a score of 80; and regulatory risk, with a score if 40.

Interestingly, these rankings remained consistent across schemes of all different sizes.

TRUST

The second section of our research looked at trust. According to our research, an overwhelming 91% of respondents believed trust was "very important" when it came to choosing and working with advisers and providers for their pension scheme, with a further 8% ranking it as "important" and 1% ranking it as "a little important".

We then asked what makes the most trustworthy firms worthy of that trust – asking them to select up to three of the most important from a list of options.

"Doing what they say they are going to do" ranked highest with 55% respondents listing this among their most important criteria.

This was followed by "quality of advice or products", listed by 51% of respondents; "strong personal relationships with key individuals", ranked by 47%; "transparent and understandable fees and costs", put forward by 45%; and "admitting mistakes if they are made", listed by 43%.

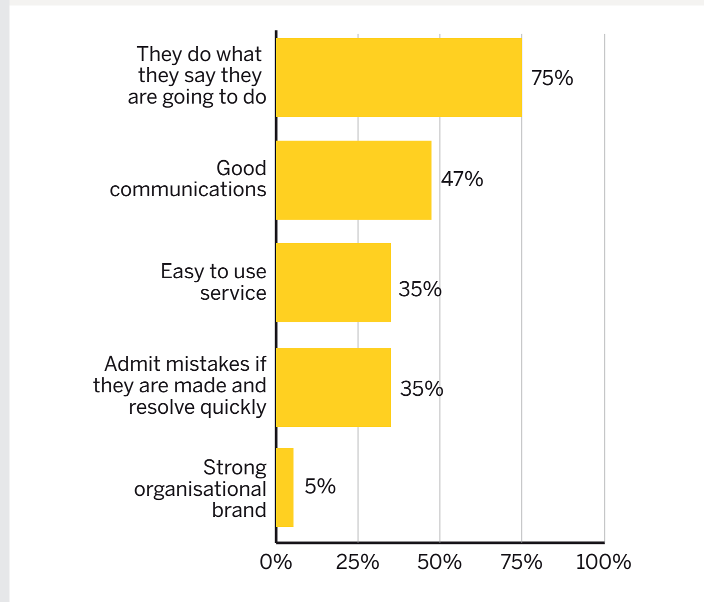
Other options, such as customer service, communications and brand were ranked less highly by respondents.

These rankings were broadly similar across respondents from schemes of all sizes.

In actuary we trust?

Respondents were also asked

What makes advisers and providers stand out from the crowd?



2%

Respondents who believed policyholder and member services were not important when it came to choosing and working with advisers and providers

how much they trusted specific organisation types – being asked to say whether they trusted a particular type of organisation "completely", "somewhat", "a little" or "not at all".

We then ranked these responses, giving each organisation a score of between one on four, with four being the most trusted and one being the least trusted.

Actuarial consultants topped this list with a score of 3.40, followed by custodians with a score of 3.22 and then third-party administrators, asset managers and investment consultants, with respective scores of 2.89, 2.72 and 2.56 respectively.

Insurance firms were close behind, with scores of 2.56 (risk reduction providers) and 2.53 (pension providers); followed by fiduciary managers, with a score of 2.47 and investment banks with a score of 1.94.

Service

We also asked respondents how important policyholder and member service was when it came to choosing and working with advisers and providers for their pension schemes.

Some 52% of respondents ranked this as very important, with a further 46% saying it was important. Just 2% believed it was not important.

In addition, we asked respondents what it was that they believe makes the advisers and providers with the best policyholder and member service stand out from the crowd. Respondents were allowed to select as many answers as they wished to this question.

Three-quarters (75%) said it was doing what they say they are going to do, 47% believed good communication was key, easy to use service was next with 35% followed by the ability to admit mistakes (35%). Brand was cited by only 5% of respondents.

How Philips UK Pension Fund executed its £2.4bn buyout

Jonathan Stapleton speaks to Philips Electronics UK pension manager Adrian Holmes and Pension Insurance Corporation actuary Mitul Magudia about the transaction

Jonathan Stapleton: Adrian, what were the key reasons for undertaking the buyout?

Adrian Holmes: The background to this is that the company and the trustees had been looking at insurance transactions for some time. And from the trustee point of view, they decided a few years ago that, in the long term, they were interested in aspiring to a buyout. The company also decided that, in the long term, this was where they wanted to be.

But last year, there was a significant corporate event, whereby the corporate decided to divide into two separate companies, both legally and financially. There was a lot of preparation around this, particularly looking at the emerging balance sheets of the two companies. And there was the question of what to do with any kind of legacies from the old Philips.

In relation to pensions, reducing the pension liabilities on the balance sheet was an important goal for the company. So this is what kicked off the move to look to see if we could achieve a full buyout of the fund and whether it was possible to complete this during 2015 in order to meet the timescale of the corporate action.

> **"The first practical consideration was actually getting the corporate's advisers into place and then looking at the options with those advisers and bringing those advisers up to speed in terms of the history and the complexities of the pension fund"**
> **Adrian Holmes**

Jonathan Stapleton: What were the main practical considerations with regards to achieving a full buyout?

Adrian Holmes: The trustees had already transacted three times for buy-ins, so a third of the fund was already insured. But that had been led principally by the trustees, with the agreement of the company, but it didn't involve any kind of capital injection from the company. This time it was very different; it was connected to the corporate move and it did involve an injection of money. So the corporate decided it needed to lead this rather than the trustees. That meant the corporate engaged its own consultants on a different level to that which it had previously.

As such, the first practical consideration was actually getting the corporate's advisers into place and then looking at the options with those advisers and bringing them up to speed in terms of the history and the complexities of the pension fund.

The next step was analysing the options and talking to the trustees.

From the trustees' point of view, this transaction meant they had to get used to working with a completely different dynamic and allow the company to take the lead in some of the conversations with the insurance companies and with its own advisers. It was a very different way of working.

Jonathan Stapleton: Mitul, how did PIC help with some of these practical considerations?

The buyout in brief

- The Philips UK Pension Fund's £2.4bn buyout – concluded with Pension Insurance Corporation in November last year – was the largest of its kind ever completed in the UK market.
- The transaction covered the pension benefits of around 26,000 UK pension scheme members.
- A key feature of the transaction was the simultaneous reinsurance of the longevity risk by PIC with Hannover Re, including an unprecedented level of non-retired members.

Jonathan Stapleton (left) talks to Adrian Holmes and Mitul Magudia (right)

Mitul Magudia: Well I think the practical considerations really were divided between the company and the trustees in terms of what was required. Both sides were working towards the same end goal, which was to achieve a full buyout for the pension scheme.

But the company's emphasis lay around things like ensuring they had an accounting settlement within the year, a point that Adrian mentioned. It also wanted to ensure that the capital injection required for the transaction was within a tolerance that they were comfortable with. And it wanted to ensure that residual risks around the transaction weren't then left to whichever form of company was remaining after the splitting of the company.

The trustees' considerations were more around things like investment strategy, the benefits of the scheme and things like the factors that would be applied to members as well as the security of the overall structure with the insurer.

So our involvement with both sides covered all of these areas. We looked to create a legal structure that allowed settlement within the year. The benefits specification itself covered all of the legal history and the benefits that the members were entitled to – and Philips has a long and complex history of benefits, with lots and lots of changes to the trustee rules over the years. So that was something that we had to work through in detail to ensure that we both understood the complexities but also could offer as an insurance policy that covered them.

"What was unusual about this transaction, compared to both the previous buy-ins Philips conducted and other large deals we've seen in the market, was that it included a large proportion of deferred members, around £1bn, which is something that hadn't previously been seen in the market"
Mitul Magudia

From PIC's perspective, there were other practical considerations and we needed to ensure we had both the appetite and capacity for a transaction of this size. And we also had to make sure we had any required reinsurance treaties in place.

Jonathan Stapleton: Did you reinsure longevity risk as part of this?

Mitul Magudia: Yes. It is commonplace for large pension transactions to have what we call back-to-back longevity reinsurance. This means the insurer will go out and source longevity reinsurance from a reinsurer and engage in that contract at the same time as signing the bulk annuity contract.

But what was unusual about this transaction, compared to both the previous buy-ins Philips conducted and other large deals we've seen in the market, was that it included a large proportion of deferred members, around £1bn, which is something that hadn't previously been seen in the market.

One of the issues with deferred members is that they require a large capital buffer to be held by the insurer, due to the volatility of life expectancy – it is obviously very difficult to predict how long a 40-year-old is going to live so

therefore insurers have to hold a lot of money against that risk.

So one of the ways of mitigating that risk is to reinsure that liability and we managed to reinsure some of those deferred lives as part of the transaction too, which was, I believe, the first time that a large amount of deferred liability has been reinsured in that way.

Jonathan Stapleton: Adrian, you've spoken a little bit about affordability and that sort of thing. I know it's a major challenge for a lot of schemes and corporates, how did Philips address that issue?

Adrian Holmes: Well, I think it did the analysis to really understand what the potential cost might be at that point in the market. But it also needed to understand the volatility of the buyout gap between what was in the fund and what full insurance would cost. And I think history helped a little bit in the sense that, having been through the buy-in processes three times, and having discussed this over a number of years, there was an understanding of the level of variability there might be and therefore an anticipation of a reasonable figure in terms of expected cost.

So it had that advantage, but it nevertheless was tight in terms of the potential for the cost to be too much. The corporate was looking for the risk that was taken off the balance sheet to be worth the cost that was being paid. And clearly it would have compared this cost with the spending of that capital somewhere else, in some other part of the business – and assessed whether there was a better spend within the business.

In terms of the overall efficiency, the corporate clearly needed the process to be very cost efficient and so was looking for any ideas that would help here. So there were some liability management exercises that were connected with this and we did a pension increase exchange exercise and an enhanced transfer value exercise as part of the process.

"In terms of the overall efficiency, the corporate clearly needed the process to be very cost efficient and so was looking for any ideas that would help here"
Adrian Holmes

The other aspect was, once it seemed that there was a potential for the cost to be acceptable, actually trying to make sure there wasn't a market movement or economic movement between the fund assets and the insurance company's pricing so we didn't experience too much volatility in the size of the buyout gap.

Jonathan Stapleton: Mitul, how can insurers help with some of these affordability issues and challenges?

Mitul Magudia: I think one of the notable aspects of the relationship between PIC and Philips has been early engagement.

In fact Adrian and I first met to discuss the pricing of full buyout over five years ago. So it's been a long journey to get to the full settlement of the liabilities and we've explored all manner of different types of transactions and different shades of potential pensioner buy-ins or full buyouts, or what could be done and what couldn't be done. And it's through the direct engagement that we've had with each other that we've managed to get to where we are now.

I think one of the other aspects that really helped was the company had a very specific idea of how much money it wanted to spend on the transaction and was willing to share that with insurers. So as part of the initial auction and process for the transaction, that number was revealed and given to insurers as a potential target. It was an aggressive target but it did show seriousness in transacting if that could be achieved. And ultimately that was achieved.

So I think knowing exactly how much you have to spend and being able to spend that is seen as very attractive to insurers – it makes you a very credible counterparty.

And the history that the Philips scheme had – both in terms of the three previous pensioner buy-ins and the conversations we'd had both with the company and the trustees – meant we knew we were dealing with a very serious counterparty that was seriously interested in transacting.

Two other things. One was that the scheme was very well funded compared to most other UK pension schemes. So while the injection was large, over £200m, that's not really large in the context of the sort of buyout deficits that other similarly sized schemes would experience. But the other area was that the scheme, over this period of five years, did a very good job of moving towards assets that were broadly in line with how an insurer might actually invest.

So there was a lot less volatility, as Adrian mentioned, between how our pricing moved over time and how the scheme's assets were moving.

In fact the alignment was to such a degree that interest rates and inflation rates were actually almost perfectly hedged between how our pricing worked and how the scheme worked. So to the extent that either inflation went up or down or interest rates went up or down, it didn't really negatively affect the scheme.

So those things all combined

to bring together a situation that allowed us to transact.

Jonathan Stapleton: Adrian, you've spoken a lot about the considerations around the deal. Were there any other elements you felt required detailed consideration when taking the deal through to completion?

Adrian Holmes: We hadn't insured any deferred members previously so we looked again at the scheme discretions we had codified for deferreds.

And there was all the preparation we needed to do for data cleansing and looking at the documentation, making sure it was all completed in good time. There was quite a lot of detailed work to run through to make sure it was comprehensive in terms of the final deal.

Jonathan Stapleton: What advice would you give to other pension schemes considering a similar transaction?

Adrian Holmes: It's all about preparation. It's well understood that you have to prepare the data but the amount of time that can take is huge – and the same is true in terms of combing through and checking the documentation. Should you find something you need to look at more closely, then it can take a lot of extra time. So start looking at that very early on.

I think also we spent a lot of time looking at governance and, not only understanding the reasons that the trustees would want to transact, but looking at the company decision and making sure the company was in the right place. The company was, as I have mentioned, leading this process itself, but we needed to make sure that, from a trustee point of view, a decision could be made quickly at the right time and without reviewing and spending a lot of time in making that decision. So making sure it can all be done efficiently is also very important.

And then, as Mitul has mentioned, the relationship with the insurance company is also very important. Once you're doing the work on the data and all that preparation, and you're clarifying in your own mind how you would make that decision, then going and talking to the insurance company is absolutely invaluable. The help that we've had from the PIC over the last five years has been absolutely incredible. It's made a lot of difference to us in terms of our preparation.

So once you're in that space, it's worth talking to the insurance companies and getting to know them and seeing what their view of your fund is – as this view can be very different to your own.

"One of the biggest things that I always say to pension schemes looking to get ready is to have a governance structure in place because, even if you know exactly what you want to do and what a successful outcome looks like to you, it may not be the same for the company"

Mitul Magudia

Jonathan Stapleton: Mitul, would you agree with that advice to other schemes?

Mitul Magudia: Yes, absolutely. I think, as Adrian says, each scheme is different and has its own challenges but, fundamentally, preparedness is something you can do regardless of whether you are thinking about insuring now or whether it is something that is going to come a few years down the line. It is wise to get ready to take advantage of a future opportunity.

One of the biggest things that I always say to pension schemes looking to get ready is to have a governance structure in place because, even if you know exactly what you want to do and what a successful outcome looks like to you, it may not be the same for the company. It's worth having that discussion up front and understanding exactly what a successful outcome to everybody would look like. That sometimes comes through joint working parties and it sometimes comes through general discussion between the trustees and the company.

Having those conversations early in the process – rather than doing all the work first and having the high level discussions right towards the end of the process – really saves quite a lot of difficulties. I'd always recommend that.

In terms of logistical things, yes, absolutely, data preparation is a useful thing to do but not at the expense of market volatility – if you think there's a good opportunity out there, don't spend six months cleaning your data; get out there, get the opportunity and sort your data out later. But if it's something that you have time to do, then do it as it can take margins out of insurer quotations.

Benefit specifications are the other area which can need significant work. They typically need a legal review and, if you're insuring deferreds, there can be quite a few considerations around things like how the factors might be insured and other areas too. So yes, I think being prepared is probably the thing to do.

To view the video of the interview, please visit: **www.professionalpensions.com/2456913**

THE PANEL

Ian Aley, head of transactions, Willis Towers Watson
Aley is the head of Willis Towers Watson's pensions transactions team and has advised on a number of landmark longevity and buy-in transactions.

Paul Kitson, partner, PwC
Kitson is the head of PwC's global pension longevity swap and buy-in network and has extensive experience of leading large de-risking projects.

Tiziana Perrella, head of buyout, JLT Employee Benefits
Perrella leads the buyout team at JLT Employee Benefits. Her primary area of expertise is advising on immediate de-risking activities such as synthetic, captive and traditional longevity transactions.

Martyn Phillips, partner, Mercer
Phillips is a partner in Mercer's UK bulk pensions insurance advisory group and has 25 years' industry experience and has been involved in all areas of the buy-in and buyout market.

The road to buyout

PP speaks to seven consultants about affordability, the risk reduction exercises being conducted at the moment and how schemes can prepare for a transaction

Q How close are pension schemes to a buy-in or buyout at the current time?

Aley: Most schemes are now reserving for their pensioners at a level which is close to the buy-in cost. Typically, what's constraining them is the need to hold their gilts for collateral purposes and/or their funding deficit. As they continue along their de-risking journey, this will change and a pensioner buy-in will be the logical next step.

For non-pensioners, the gap between what the trustees are reserving and the insurer pricing is wider – as most schemes will have a largely return seeking asset strategy for non-pensioners. This gap will take longer to close without additional contributions, and so for most schemes a full buyout is some years away.

Kitson: PwC's recent pension risk survey showed that UK pension schemes have fallen into two distinct groups. The first group have quietly been de-risking over the last few years, biting the bullet of the costs associated with hedging interest rate and inflation risk. These funds now find themselves in a good place versus buy-in/out, having been protected from recent further falls in interest rates and at an opportune time are able to look to move to buy-in/out with acceptable cost.

However, there is a second equally substantial group that still have very low hedge ratios and, as interest rates have continued to fall, have found themselves a long way from buy-in/out and are having to continue to run substantial investment risk to reach a position where they can consider moving to buy-in/out.

As expected, there are a number of schemes in the second group that have weaker sponsors, whose de-risking ability has been constrained by the inability to increase cash into the scheme over the last five years.

> **"Data preparation for buyout by schemes is better (but far from perfect) – but legal due diligence required for buyout is catching a lot of schemes out"**
> **Paul Kitson**
> **PwC**

Our view is that data preparation for buyout by schemes is better (but far from perfect) – but legal due diligence required for buyout is catching a lot of schemes out. You can gloss over this for a buy-in as you can base a buy-in on whatever benefits you want, but for a buyout you have to know exactly what all the benefits the scheme has promised over the years are and evidence this to the insurer. When schemes have come to do this they have often found a depressing smorgasbord of missing deeds, incomplete legal documents and historic changes that were not legally enacted.

All of this can be dealt with if you have time, but in the heat of executing a buyout the only way to solve these data and legal benefit entitlement issues is to pay a higher premium to insure higher benefits. The cost of this can be substantial.

Perrella: It is very hard to provide a general answer given the vastly different circumstances of UK pension schemes. A scheme with a significant proportion of pensioner members, funded 70% or more on a solvency basis, with some matching assets such as gilts and bonds will most likely be able to afford some form of bulk annuity purchase.

Trustees could opt to 'top slice', or apply any other method of tranching, in order to secure benefits which are best value for money at any given time. It is disappointing that schemes are generally not well prepared to go to market – data quality can be hit and miss and schemes are still exposed to risks connected to their legal documentation not being complete or correct. This is work that does not go out of date, and should be undertaken by all schemes.

Phillips: Without scheme-specific insurer pricing, it is difficult to quantify how close schemes really are to a buy-in or buyout as the solvency liabilities of pension schemes, normally the best estimate of a buy-in or buyout that a scheme actuary can provide, can materially differ from actual insurer pricing, in some cases, by up to 10%.

The cost of a buy-in or buyout is normally assessed as the difference between the best insurer premium/proposal and the scheme's assets or technical provisions. Ultimately, with many schemes still under-funded on an on-going technical provisions basis, this means in many situations there will be a cost or strain to completing an insurance transaction. However, there are a large number of schemes that are funded on prudent bases and have successfully completed transactions with no additional funding being required from the scheme sponsor, and in some cases, at prices below

THE PANEL

Tom Seecharan, director and head of pensions insurance, KPMG
Seecharan leads KPMG's 30-strong specialist UK pensions insurance team. He has 15 years' experience advising on, assessing and managing pensions risk, with a particular emphasis on pensions risk transfer.

Michael Walker, principal consultant, Aon Hewitt
Walker is a principal consultant and risk settlement adviser at Aon Hewitt and advises on the full range of risk settlement structures, with a particular focus on bulk annuities and longevity swaps.

Clive Wellsteed, partner and head of de-risking practice, LCP
Wellsteed heads LCP's de-risking practice. He is also a scheme actuary and provides corporate advice to a small number of clients.

the scheme's own technical provisions.

Cost can be a significant bar to some schemes but it really is a case of each scheme on its own merits – with some schemes already funding toward buy-in or buyout and/or with a sponsor with a strong balance sheet who might be willing to fund any shortfall.

Seecharan: Cost can be a bar to many. Insurance pricing is currently relatively high due to a tightening of credit spreads and high demand for swaps exacerbating the continued low yield environment. Solvency II is also likely to increase insurer costs for deferred members. Well-hedged schemes are faring well, however.

Many schemes are undertaking some form of work to get transaction ready. At one end of the spectrum this could involve cleaning data, undertaking feasibility studies etc. The best prepared schemes are those which have already begun talking with insurers. This group is in a position to transact very quickly to take advantage of favourable market conditions having already agreed preliminary pricing and terms with insurers.

Walker: Volatility in equity markets and low government bond yields mean that many schemes will not currently be in a position to execute a full buyout. However, partial buy-ins can be tailored to a scheme's current funding positon and investment objectives. Partial buy-ins for current pensioners remain good value relative to an investment in government bonds so cost should certainly not be a bar to schemes considering insurance based solutions.

A significant number of schemes need to take further steps to prepare for an insurance transaction. For example, only a quarter of schemes have an established criteria as to when they would transact, while only around half are confident that they have the data an insurer would need to complete a transaction. Conducting a de-risking feasibility study allows trustees and sponsors to clarify their de-risking objectives, understand the impact a transaction would have on their scheme and put in place a plan of action to facilitate a successful settlement.

> **"Volatility in equity markets and low government bond yields mean that many schemes will not currently be in a position to execute a full buyout"**
>
> **Michael Walker, Aon Hewitt**

Wellsteed: In short, many schemes could complete a competitively priced pensioner buy-in at the current time, but most are a few years away from buyout.

At our webinar earlier this year we asked the 100-strong audience how long they expected to take to reach buyout or self-sufficiency. Some 54% answered between five and 15 years, with 12% less than five years away. Over 80% said that they expect to do an initial transaction (ie a buy-in or longevity swap) ahead of reaching full funding with 50% expecting to do that initial transaction within the next five years.

Cost is not a barrier for pensioner buy-ins given current attractive pricing levels. Where the buy-in is met from gilts or other low-risk holdings there is typically a funding gain reflecting buy-in pricing is currently slightly better than a gilts valuation.

Cost is a hurdle for full buyouts as most pension plans continue to have a significant shortfall in assets compared to the full buyout cost. However, there is increasing corporate appetite to meet the cost particularly where it helps facilitate corporate activity. Last year Philips paid a significant cash injection into its UK pension fund to achieve a full buyout ahead of its demerger earlier this year.

Q To what extent is there significant pent-up demand among schemes waiting for costs to fall?

Aley: There is certainly pent-up demand. If pricing in the buy-in market improves relative to scheme assets, it is likely that more and more schemes would consider moving to annuitisation. From an asset perspective, improvements in funding levels driven by rises in equity markets would also lead to more schemes taking action.

A significant number of the schemes we advise are currently monitoring both their funding level and buy-in pricing on a daily basis so they are able to quickly identify pricing opportunities.

Kitson: Our pension risk survey suggests that if interest rates increase by 1-2% across all durations then you could see transactions worth tens of billions of pounds coming to the buy-in/out market relatively quickly.

Many schemes are working towards a long term target of buyout or self-sufficiency where buyout is likely as they reach full funding on this basis.

Perrella: The majority of UK defined benefit schemes will discharge their liabilities via a buyout, or a series of buyouts, at some point – the alternative is to run the scheme until the last pensioner dies, which would not make financial sense. This, and the sheer size of the DB sector, against the insurance sector's appetite for longevity

> **"The majority of UK defined benefit schemes will discharge their liabilities via a buyout, or a series of buyouts, at some point – the alternative is to run the scheme until the last pensioner dies, which would not make financial sense"**
>
> **Tiziana Perrella, JLT Employee Benefits**

risk, suggests a huge amount of pent-up demand, and we expect supply-side issues to become manifest over the next few years. These are already becoming evident for smaller schemes.

Some trustees and sponsors have delayed approaching the market in the expectation that prices will fall when yields pick up. However, as the expectation of yields increasing in future is already reflected in asset and annuity prices, this would not necessarily improve affordability. There is also the issue that if a large number of schemes rush to market at the same time, not all of them will be able to get quotes. Therefore, settling a scheme's liabilities now for a low, but known, yield looks like a sensible course of action.

Phillips: There is no doubt in my mind that latent demand for buy-ins and buyouts is vast. There are probably only a small number of schemes who wouldn't complete a buy-in or buyout if they had the financial resources to do so. However, adopting a strategy of waiting for insurance premiums to fall needs careful consideration. If insurance premiums do fall, say, as a result of increasing yields, then, firstly, it is likely that scheme assets/liabilities will have also fallen in value and, secondly, many other schemes may also be in a similar position and thus competing for what might be limited insurer capacity.

As a general point, demand is also set to increase as the natural passage of time makes it easier and cheaper to externalise liabilities via insurance as pension obligations become more certain as overall liability durations become shorter.

Seecharan: As more schemes sign up to more sophisticated price discovery and real-time tracking approaches, we expect pent-up demand to increase. In recent years, a growing share of market activity is in respect of pension schemes going back to the market to insure additional tranches of their liabilities. Those who have traded before represent a far more straightforward and attractive prospect for insurers to trade with and will often be at the front of the queue when conditions improve.

"There are probably only a small number of schemes who wouldn't complete a buy-in or buyout if they had the financial resources to do so. However, adopting a strategy of waiting for insurance premiums to fall needs careful consideration"

Martyn Phillips, Mercer

Indeed, with around £350bn of pension scheme liabilities relating to schemes with buyout funding levels at 75% or over, insurance activity will be driven by this population in the short term and this could take up a large proportion of the capacity in the market.

Walker: Demand is likely to outstrip short-term capacity should there be a significant improvement in affordability. There are around £2trn of UK DB pension liabilities of which approximately £60bn have been insured to date. Even allowing for those schemes that do not have a buyout objective, with only around £15bn of bulk annuity contracts currently written each year, it is clear that there could easily be many more schemes wishing to transact than capacity exists for in the current insurance market.

Schemes need to ensure that they are at the front of the queue when a buy-in or buyout become affordable for them and take actions now to ensure they are fully prepared to take advantage of opportunities in this area.

"With around £350bn of pension scheme liabilities relating to schemes with buyout funding levels at 75% or over, insurance activity will be driven by this population in the short term and this could take up a large proportion of the capacity in the market"

Tom Seecharan
KPMG

Wellsteed: There is significant pent-up demand which is likely to be released should funding levels improve.

We estimate that only one in 10 FTSE100 companies with UK pension schemes are over 80% funded on full buyout. This would double to one in five FTSE100 companies if there was a 15% rise in equities and similar assets. It would more than triple to one in three FTSE100 companies with a 30% rise. Rising interest rates would have a similar effect.

These dynamics show how the market could change very quickly. Despite insurer capacity being at record levels, demand could quickly outpace it, putting upward pressure on pricing.

Q What are the risk reduction exercises schemes can conduct ahead of an insurance-based solution? What sort of exercises are being conducted currently?

Aley: For pensions currently in payment, there are two main options. Firstly, those members with small pensions, where the fixed costs of insuring them are significant, could be offered a lump sum. Secondly, members could be offered the option to exchange their non-statutory pension increases for a higher level pension. This can be particularly useful in reducing the buy-in cost where the pension increases are unusual and therefore difficult for the insurer to hedge – for example pension increases with an annual floor of 3%.

For non-pensioners, we are currently working with a large

number of schemes who wish to offer members more flexibility at retirement. Recognising that an increasing pension with a spouse's pension attached no longer necessarily meets members' needs, both trustees and companies are facilitating members transferring their benefits at retirement. This gives the members flexibility to access their pension in a more flexible defined contribution environment, and typically leads to savings relative to the buy-in cost.

Kitson: Most of the focus is currently on pension increase exchange (PIE) and flexible retirement option (FRO) exercises.

PIE is where you offer the member who has a pension of say £10,000 per annum which increases with RPI, a pension of £12,000 per annum which does not increase. This can be beneficial for buy-in/out as insurers need to load in risk margins for inflation-linked pensions due to the additional risk factor.

FRO is where you offer members over age 55 but who have not yet retired the opportunity to transfer their pension to income drawdown or to buy an immediate enhanced annuity. This can be beneficial for individuals. Once a member has started drawing his pension in a DB scheme he loses the ability to transfer to drawdown or buy an enhanced annuity, hence you run the exercise for those not yet retired. FRO helps buyout costs as members are potentially leaving at a lower cost than it would cost to buyout their DB pension.

Both exercises fall under the FCA Code of Good Practice and are likely to require financial advice to the individual.

We have seen take-up rates anywhere between 5% and 50% for these exercises, which is quite diverse.

Finally, conducting a medically underwritten buy-in/out of the largest liabilities in the scheme can be a good way of cheapening the overall buyout cost. There used to be a concern that if you got a good price on the medically underwritten large liabilities you may make what was left of the scheme less attractive to buyout providers, but I think this has changed now. However, you do still run the risk though that you discover all your large liabilities are super-healthy and once you have discovered this you cannot forget it, as it would be disclosable to all buyout providers and so could therefore increase the cost. However across all schemes overall on average we would expect it to decrease the cost.

Perrella: Liability reduction exercises can be run as follows:

- Enhanced transfer values (ETVs) – allow deferred members to transfer an uplifted value of their benefits to an alternative arrangement.
- FROs – allow deferred members aged 55 and over to retire early, or to take a transfer value and secure benefits in a different format from their scheme benefits, or to use funds for draw down purposes.
- PIE exercises – allow pensioners to exchange non-statutory increases for a higher immediate pension with lower future increases.
- Trivial commutations (TCs) – allow members with low value benefits to cash these in.

The most common exercises at the current time are PIEs and TCs – these can easily be carried out at the same time as a bulk purchase annuity broking exercise and, indeed, the trigger for a bulk annuity purchase can be agreed to fit in with the expected outcome of one or more of these exercises.

A bulk annuity purchase can also follow investment side de-risking, essentially swapping matching assets such as gilts and bonds for a complete liability hedge, also covering longevity risk.

Phillips: We are seeing an increasing number of schemes considering liability management exercises: PIEs, ETVs, FROs TCs and, for those contemplating buyout, Winding Up Lump Sums (WULS). It is now possible – with the support of pension scheme trustees – to re-engineer the finances of pension schemes of all sizes to support the outcome the sponsoring employer is seeking.

We see opportunities for creating value via a coordinated and combined approach that allows members to exercise options, supported with high-quality personalised financial advice, against a background of annuitisation. This kind of joined-up approach delivers improved value for individual members and can enable economic settlement of pension liabilities for those remaining in the scheme at a cost well below initial expectations.

Seecharan: A PIE can convert inefficient and costly pension increases into level or fixed

"The most common exercises at the current time are PIEs and TCs – these can easily be carried out at the same time as a bulk purchase annuity broking exercise and, indeed, the trigger for a bulk annuity purchase can be agreed to fit in with the expected outcome of one or more of these exercises"

Tiziana Perrella, JLT Employee Benefits

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Martyn Phillips, Mercer

increases which insurers are better able to price attractively. For schemes looking to buyout, running a transfer value exercise may also prove a popular option with members as the transfer value basis could worsen for members following an insurance transaction.

On the asset side, one important form of de-risking is to hedge interest rates. For many years now, the majority of liabilities have remained unhedged against this unrewarded risk, waiting for conditions to improve. The problem is that, contrary to all market expectations, yields have continued to fall, meaning schemes that chose to hedge, thereby locking-in the market's more optimistic expectation, have benefited and it is largely those schemes who are currently insuring their liabilities.

Walker: There are two main avenues schemes can explore to reduce risk ahead of a transaction.

The first is to reduce liabilities from the scheme which would be expensive to insure such as deferred pensions. This can be achieved through offering options to members. Running an exercise to highlight the option to take a transfer value can generate significant take-up rates with substantial savings relative to insurance pricing as well as reducing the overall risk within the scheme.

Secondly, schemes can consider reshaping benefits to make them more attractive to an insurer. Pension increases linked to CPI or with certain caps and collars can be comparatively expensive to insure. Schemes can run a PIE exercise to allow current pensioners the option to exchange their current inflation linked pension for a higher fixed pension. This removes uncertainty in the level of future pensions payable by insurers leading to material price savings. In addition, schemes can offer this as an ongoing option to deferred members at retirement similarly preparing the scheme for a more cost-effective insurance solution coupled with providing increased flexibility for members.

Wellsteed: There are four common exercises which can help to reduce risk ahead or as part of a full buyout. These are PIEs, ETVs, FROs and trivial commutation exercises. In our experience average take-up of these can be 10-30% and tend to be initiated by the company particularly if they will be paying a cash injection into the scheme.

These exercises can provide members with greater flexibility in the form in which they take their pension whilst allowing the pension scheme to settle their obligations at a lower cost than buyout.

At the point of buyout a much higher limit applies on trivial commutation meaning that schemes can sometimes offer a significant proportion of their members a cash lump sum rather than an annuity.

> **"On the asset side, one important form of de-risking is to hedge interest rates. For many years now, the majority of liabilities have remained unhedged against this unrewarded risk, waiting for conditions to improve"**
>
> **Tom Seecharan**
> **KPMG**

Q What can pension schemes do right now to ensure they are ready to transact when affordability becomes less of an issue?

Aley: If a buy-in or buyout are within a scheme's short- to medium-term plan, I would recommend they consider the following steps:

• Prepare their data. Data items that are not needed for day-to-day administration are more important for a bulk annuity – such as spouses' pension amounts. For larger schemes, ensuring mortality experience data is good quality and information rich can significantly help pricing.

• Gather spouses' information. Understanding the proportion of your members that are married, and the age of their spouses, is valuable information in order to enable insurers reduce prudence within their assumptions.

• Prepare a benefit specification. In my view, this is always a good investment for a scheme, whether a buy-in is on the horizon or not, as it ensures the scheme is being run correctly.

• Ensure all investment decisions recognise the possibility of a future transaction. This includes thinking about both the liquidity of asset classes, entrance and exit costs and whether an insurer would find them attractive to in-specie transfer.

In addition to these practical steps, agreeing the governance framework for any transaction – for example agreement of objectives with the sponsor – will ensure schemes can act quickly if market opportunities arise.

Kitson: Data due diligence appropriate to a buy-in/out – and not just a 'business as usual' data audit – is one step.

Another is conducting a review of the historic legal documents of the scheme, and not just the latest trust deed and rules as the older documents are still likely to apply for most of the deferred and pensioner population.

Perrella: In advance of approaching the market, trustees should:

• Check their scheme rules to confirm that the scheme has

> **"In addition to these practical steps, agreeing the governance framework for any transaction – for example agreement of objectives with the sponsor – will ensure schemes can act quickly if market opportunities arise"**
>
> **Ian Aley, Willis Towers Watson**

been administered correctly – it is disappointing how many schemes still discover problems with their equalisation approach.
• Cleanse their data, including verification of members' benefits, calculation of spouses' pensions, and carrying out existence checks.
• Obtain any preliminary advice or training on bulk annuities which may be required – this could include preliminary due diligence considerations in respect of the various insurers.
• Consider a suitable trigger for a transaction, taking into account their investment strategy and funding plans, and involving the sponsor if sponsor support is likely to be needed.
• Consider whether any liability de-risking exercises should be carried out, and whether these are best undertaken before or at the same time as a bulk annuity purchase.

Phillips: If and when affordability becomes less of an issue for more pension schemes, we could be faced with a situation where demand for pensions insurance outstrips supply. Given the market has historically completed only 150-200 deals in any one year – representing only a very small proportion of the c.6,000 private sector DB schemes – there is a real risk of capacity constraints in the market, not just from an insurer capital perspective, but also from a resource and expertise perspective.

We saw this happen in 2008 and lots of schemes experienced a situation where they were unable to attract a sufficient amount of insurer interest and unable to transact in their desired timescales – resulting in many missing the boat.

We believe schemes should be creating a level of engagement with insurers well in advance of a transaction and ensuring that their scheme data is in good order to help facilitate a transaction in due course.

Seecharan: There is nothing stopping a pension scheme going to market now and getting quotes from insurers. This underpins the accelerated buy-in approach we introduced in 2013 and

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> **Mercer**

which has been delivering great outcomes as it gets the harder, more time consuming tasks out of the way in advance, meaning that these pension schemes are at the head of the queue should financial conditions improve. Put together with the ability to track pricing and market conditions in real-time, using tools such as KPMG Fusion, this gives pension schemes the ability to transact within days, take advantage of a volatile market and achieve significant savings (3% to 10%) against expected pricing.

Insurers also favour this approach, as it allows them to quickly match their order books with pension schemes, particularly where they are aware of the price a pension scheme would need in order to transact.

Walker: Schemes can perform high level feasibility studies and conduct training for trustees and the sponsor so that future insurance decisions can be made with a comprehensive understanding of all the options available in the market. A typical feasibility study would look at the impact of a transaction on the scheme's technical provisions, recovery plans, accounting position and investment strategy.

Another key step is ensuring the scheme has clean data and a clearly specified benefit structure. Insurers price transactions based on the information provided and uncertainty leads to caution and higher prices.

The risk settlement market is busy and insurers already reject unattractive opportunities. Schemes need to demonstrate commitment from both the sponsor and the trustees to completing a transaction as well as affordability and adequate preparation.

Wellsteed: Our advice is always to be ready to move quickly to seize opportunities. Insurers offer the best opportunities to those schemes that are well prepared with good data and good governance.

Data does not need to be perfect but must be sufficient for the insurer to optimise their pricing such as marital status and mortality experience.

Good governance will allow trustees and sponsors to make the complex decisions required in the timescales necessary. Real-time pricing tools, such as LCP Visualise online price tracker, can provide valuation information to help decide when to engage with the market. The price tracker displays a range of pensioner buy-in prices tailored to the scheme using live pricing yield curves from the insurers.

Q What innovations are currently being introduced into the market to help schemes reduce risk?

Aley: The ways that schemes are measuring longevity risk is an area of innovation. We've used stochastic techniques to help schemes understand the potential financial impact of longevity for many years and have recently

> **"Consider whether any liability de-risking exercises should be carried out, and whether these are best undertaken before or at the same time as a bulk annuity purchase"**
>
> **Tiziana Perrella, JLT Employee Benefits**

launched PulseModel to enhance this. PulseModel uses medical science and the views of medical experts to improve predictiveness – incorporating the impact of medical conditions, such as diabetes, to inform future mortality patterns and the associated risks.

The way in which schemes are monitoring buy-in and buyout pricing has also seen recent innovation, with tracking tools such as our Asset Liability Suite closely linked to insurer pricing to ensure that schemes understand the cost of transactions on a daily basis.

Finally, innovation has made buy-ins well-managed, quick and cost-effective for small schemes. Our streamlined bulk annuity service uses pre agreed legal contracts to give access to terms which have generally not been available to smaller transactions.

Kitson: Volatility controlled equities can be a good way of managing risk associated with equities.

In addition, data visualisation tools, such as PwC Trade Ready, can be used to assess data risk even for very large schemes using new computer packages.

As well as this, longevity swap structures, such as PwC's Iccaria, which you can transfer to your buy-in/out provider means that longevity hedging is not a barrier to buying-in/out later, enabling schemes to reduce life expectancy increase risk on the journey to buy-in/out.

Cloud based valuation and risk systems such as Skyval Insure are allowing buy-in/out pricing to be obtained from the whole insurer market in days not weeks now.

Perrella: The most recent innovation from insurers is around payment terms, to deal with cases where affordability, rather than cost in absolute terms, is the key problem. Contract structures allowing for premiums to be paid over an extended period of time are not particularly new, however they have had to be redesigned in some cases to make them Solvency II friendly.

In general, trustees accept that de-risking their pension scheme will most likely be a gradual process, with successive tranches being settled at various times. We believe that setting formal buy-in triggers will become increasingly common as part of a pension scheme's overall investment strategy. This would work particularly well within a fiduciary setup, as investment managers, acting on behalf of the trustees, will be able to transact quickly and efficiently when circumstances allow.

"The risk settlement sector is incredibly fast moving. In recent years we've seen the creation of medically underwritten bulk annuities – a market that grew from a standing start in 2013 to over £1bn of transactions in 2015"

Michael Walker
Aon Hewitt

Phillips : We continue to see more and more risk reduction strategies for schemes, ranging from innovations on the investment side, to new and refined solutions on the liabilities side, such as the utilisation of captive structures, medical underwriting/top-slicing deals and longevity swaps being made available to much smaller schemes. We are also seeing an increase in technology-led solutions to help better position schemes with insurers.

Seecharan: The insurance market has seen significant innovation recently with insurers willing to specialise by size or type of transaction to gain or maintain market share. Recent innovations include technology-driven price tracking, top-slicing (insuring the largest liabilities to access better pricing and better value for money in terms of risk control), medically underwritten transactions and member option driven transactions.

KPMG's latest innovation is Group Insure, which allows smaller pension schemes to access the favourable pricing and competitive tension enjoyed by the largest insurance transactions and also save significant amounts on advisory and implementation fees. Alongside these new approaches, previous innovations, such as Accelerated Buy-In continue to deliver significant savings and risk reduction.

Walker: The risk settlement sector is incredibly fast moving. In recent years we've seen the creation of medically underwritten bulk annuities – a market that grew from a standing start in 2013 to over £1bn of transactions in 2015.

In 2016 and beyond we see some of the innovations created for larger pension schemes flowing through to smaller transactions. For example all-risks policies, where insurers take on broader risks such as missing beneficiary cover, are now available for some £50m transactions.

Increasingly we also see the combining of liability management techniques with risk settlement. Reshaping or reducing a pension scheme's liabilities in advance of insurance can lead to significant price improvements.

Wellsteed: We have developed LCP LifeAnalytics providing schemes with technology to measure longevity risk and identify when and how to transfer longevity risk compared to other de-risking opportunities.

LifeAnalytics models longevity risk at an individual member level allowing schemes to measure longevity risk robustly and reflecting their own scheme's membership. We have integrated LifeAnalytics into LCP Visualise, our online real-time valuation system, to help schemes analyse whether reducing investment risk, longevity risk or both offers the most risk reduction for a given spend. It can also help answer questions such as whether a concentration of risk in larger pensioners justifies a top-sliced buy-in at current market pricing and so on.

How the Total UK Pension Plan completed its £1.6bn buy-in

Helen Morrissey speaks to Total group pensions manager Lester Farrant and Pension Insurance Corporation actuary Mitul Magudia about the deal

Helen Morrissey: Can you give us a little bit of background as to what were the objectives for doing the buy-in?

Lester Farrant: Yes. We are quite a large pension plan, with overall liabilities of around £2.6bn. The scheme is quite mature and we've got lots of pensioners. I suppose like many big pension schemes, over successive valuations, we've taken lots of hits on things like longevity. And we've seen those valuations working against us.

So, between the company and the trustee, we were looking at ways we could de-risk and take some of the volatility out of the funding, give the business some more certainty and, for the trustees, more guarantee that they're going to be able to give their members the benefits. So it was really all about taking some risk out of the system.

Mitul Magudia: And I think the objectives of the Total plan are very similar to other schemes that we talk to in the market. Typically, the one difference that you do see is between the company and the trustees. Sometimes we see company-led processes for pensioner buy-ins, and their main goal tends to be controlling funding and the volatility of funding in particular. So they're looking towards their financial statements and seeing if they can control some of the ups and downs that they get year on year.

Trustees typically tend to be looking for either security of member benefits or further de-risking of the investments as part of a journey plan they may be on. And in this case it was a combination of both from our perspective – I think we had both the company and the trustee looking for slightly different things, but there were areas in which both could benefit.

> **"There came a point when the market moved a bit and we became aware that we could potentially do a buy-in for about the same cost as a longevity swap"**
> **Lester Farrant**

Helen Morrissey: Lester, what alternatives did you consider alongside a buy-in?

Lester Farrant: Well, as far as the scheme was concerned, over the years we'd de-risked some of our investments so had quite a significant holding in index-linked gilts, alongside a few corporate bonds, including some Network Rail issued index-linked bonds. So we were moving towards de-risking but we were doing it very simply, in the most straightforward way we could, rather than going down the full liability-driven investment (LDI) route, which we felt was too complicated.

But a couple of years ago, we started looking at longevity risk and, in particular, started looking at longevity swaps. But there came a point when the market moved a bit and we became aware that we could potentially do a buy-in for about the same cost as a longevity swap. We thought, if we were going to spend money, why not spend money that takes out the investment risk as well?

So, in short, it was a long project, which started off as a longevity swap. We had all our index-linked gilts, we felt we were fairly well protected but it turned into something bigger as the market changed.

Mitul Magudia: Pension schemes, and particularly large pension schemes, have been

The buy-in in brief

- Total UK Pension Plan's £1.6bn buy-in – concluded with Pension Insurance Corporation in 2014 – was, at the time of the transaction, the second largest buy-in ever completed in the UK market
- The transaction covered £1.6bn of pensioner liabilities. The plan has total liabilities of around £2.6bn
- The trustees of the plan said the PIC were able to conclude the transaction – which has brought certainty to a large portion of the scheme's liabilities – within a tight timetable

Helen Morrissey (left) talks to Lester Farrant and Mitul Magudia (right)

inundated with various solutions and options with which to manage all of their different types of risks. Lester mentioned longevity swaps being an obvious one for longevity, alongside buy-ins, as well as investment de-risking. There are also other solutions out there for big schemes like captive insurance and things like this. So it's often quite difficult to make your way through all of these solutions and try and understand which one suits your scheme best. And certainly any kind of investigation that goes into true depth takes some significant time. And there's only a limited amount of resource that any pension scheme has, or amount of cost it wants to incur, in looking at all of these different options.

Often, a good way to do that is to find an adviser who is impartial to any of the results. Through that you can get an unbiased, generalised opinion as to which one offers the best value and fits the scheme in the best way and is best for the members in that scheme.

Helen Morrissey: Lester, can you tell me how was the buy-in achieved?

Lester Farrant: I suppose I should say by putting lots and lots of hours in! I think what was good from our side, as Mitul said, was that we really had the company and the trustee aligned in terms of wanting to de-risk and searching for the most appropriate way to do that. So I think getting that agreement of the way forward, right at the outset, was very important.

But as Mitul noted, we only had a limited resource in-house so we needed to find ourselves a good adviser to help us through. Mitul might call it simple; from our side it seemed quite a complicated path to go through. But from that, we were able to go through a series of quotations with various insurance companies before homing in on Pension Insurance Corporation.

So yes, it was a long process, but I think it was key to get the company and the trustee basically recognising that they ultimately had the same objective, which is to deliver to the company's staff the pension that they've been promised. So it was great to start from that. I know sometimes we hear that there's maybe a bit more conflict; well I don't think we ever had that position as we went through this.

Mitul Magudia: Yes, I say 'simple' but I think I'd add to that 'but thorough' in this particular case because the trustees, the trustees' advisers, the company, the company's advisers, and both Lester and his team were very interested in understanding every aspect of the transaction in full detail. That required intense work from all sides to understand and establish what was being done.

In terms of how was this actually achieved, as Lester mentioned, a joint working party was set up between the company and trustees, which established a streamlined process and also a process for quick decision-making. It meant that they were open to new ideas and also tweaking the transaction in a way that suited them, but also listening to what the insurers and what Pension Insurance Corporation had to say and tailoring something that worked for both sides.

> **"The trustees' advisers, the company, the company's advisers, and both Lester and his team were very interested in understanding every aspect of the transaction in full detail. That required intense work from all sides to understand and establish what was being done"**
> **Mitul Magudia**

Helen Morrissey: What was the outcome of the transaction for the pension fund and Total?

Lester Farrant: I think we both had common objectives. What we've done is to take a big chunk

of risk out of the scheme. We have got security of our cash flows now, so we're not worried about having to disinvest certain assets and selling assets at a poor time to fund next month's pension payments. So I think that security and taking a big chunk of risk off the table, is the main outcome as far as the scheme is concerned.

Helen Morrissey: It seems like there have been a lot of lessons learnt during this process. What advice would you give to other schemes who are perhaps considering undertaking similar transactions?

Lester Farrant: I think there are probably a few bits of advice. I think the key one is what we talked about: being sure about what it is you want for the scheme and the company. Because if you don't work together, it could well have a funding impact and the company is on the hook for that. And that's key.

I think the other thing is data; you need to be sure that your data is as good as possible. The better you can get your data, the more accurate a quote you'll get from the insurance company, and the more confidence they will have that they're actually quoting for something you really have.

So nobody should underestimate the time involved in getting your data as clean as possible. And that is, I think, key.

Helen Morrissey: Mitul, anything to add?

Mitul Magudia: I think that's exactly right. I think I'd reiterate some of the earlier points on having the ability and the willingness to transact. The knowledge of that alone is so useful to schemes before they even approach the market. And I think it certainly leads to a better process, both from their perspective and from the insurer's perspective.

Secondly, I'd reiterate Lester's point about getting everything lined up – having your benefit specifications reviewed by your legal advisers and your data cleansed so that everything is

"If you don't work together, it could well have a funding impact and the company is on the hook for that"
Lester Farrant

ready for you. And also assessing what the potential funding strain might be, either on an accounting basis or on a technical provisions basis. All of this information can be done by your advisers before you even come to the market.

So it's very much a case of getting ready so that you don't find a point in the year when suddenly you think it is a great

"What we are seeing at the moment is a bit of a shift towards more demand, rather than supply"
Mitul Magudia

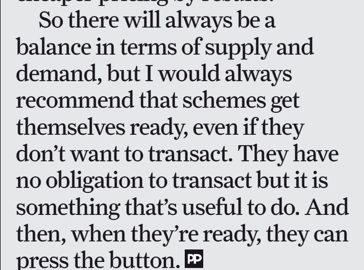
time to do a buy-in but you're not ready and find you have missed the opportunity. Because it's not something you can just do overnight; you can't just press the button. It takes months and months. Even with a scheme as developed and sophisticated as the Total scheme was, it took around six or seven months from the moment the process began to the final transaction.

And more broadly, for other schemes, my advice would be around the supply/demand dynamic. What we are seeing at the moment is a bit of a shift towards more demand, rather than supply. And given the amount of defined benefit pension liabilities out there, this is likely to be a trend we will see over future years as well.

You can quite quickly see how, if momentum starts to move towards schemes looking to de-risk quicker, and if favourable pricing is available in the market, how the demand is going to increase to a point where insurers will be more selective about who they quote for – pricing will inevitably go up for some schemes and you will see cases where schemes end up pitching themselves to insurance companies, rather than the reverse situation where we are now.

The flipside to that is there are more insurers coming to the market. The market is expanding. And also, with the freedom and choice changes, some of the other more established insurers are moving away from the individual annuity market and into the bulk annuity market, which is providing more capital and cheaper pricing by results.

So there will always be a balance in terms of supply and demand, but I would always recommend that schemes get themselves ready, even if they don't want to transact. They have no obligation to transact but it is something that's useful to do. And then, when they're ready, they can press the button.



To view the video of the interview, please visit: **www.professionalpensions.com/2395518**

Trust in pensions

Trust in financial services firms fell following the financial crisis. But does this lack of trust replicate itself in the institutional pensions market? This Q&A looks at the issues

Stapleton: If I might begin by citing some of the research we have conducted in association with Pension Insurance Corporation which found 91% of scheme managers and trustees believe trust is very important when it comes to choosing and working with advisers and providers for pension schemes. Yet, when asked, scheme managers and trustees had a varying degree of trust in their providers, with some having relatively low levels of trust in their consultants, providers or investment managers. Is there a problem with trust in the institutional pensions market?

Ellison: Well, you're going to get a legal answer which is yes and no. The answer is there is a big problem with trust because there's been a perfect storm as far as consumers are concerned. Every time they touch a pension, something goes wrong. There's a scandal in the press, the fees are alleged to be too high, people steal the money; and, virtually every week, there is something in the newspapers about the failure of a pension system – British Home Stores, Austin Reed, Tata and British Steel are just the latest of those episodes.

So the general perception among the public is that pensions are not as good value as they should be and that people are making money out of them and it's not the consumer.

So far as the institutional issues are concerned, in other words, trustees dealing with the institutions, I think the situation is not as bad as people think. If you don't trust your adviser or you don't trust your investment manager, you shouldn't be dealing with them in the first place. I think most people in the industry, the trustees, the pension scheme managers and the employers, by and large, will trust the people they're dealing with on a day-to-day basis because they know them pretty well. And if they lose the trust, they're going to lose the business.

> **"The general perception among the public is that pensions are not as good value as they should be and that people are making money out of them and it's not the consumer"**
> **Robin Ellison**
> **Independent trustee and lawyer**

One final comment, if I may. A lot of this distrust has emerged because of the *Daily Mail* and their equivalents as well as the regulators and the government obsessing about what to me are relatively minor issues such as fees and transparency. As a trustee, I'm worried about the fees, but it's not the core issue for us, nor is transparency, provided the returns are meeting our requirements. What goes on underneath is a second order issue for us. This obsession by government on creating additional regulation, and causing additional costs and compliance issues, is a real worry.

Gull: I would echo the sentiment that, at the consumer level, people have been told they were going to get a pension from an organisation and have relied on that promise for a comfortable retirement. And there's a lot of news about now saying some of those people will not get all the pension they've expected. I think part of the reason for that is the economic assumptions that were made many years ago have changed enormously and the world we're in is one of incredibly low yields and one in which the ability to get returns is also very low.

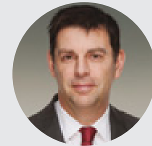
In the institutional market, I think that if you're working with people on a regular basis, you can develop a relationship with them and trust comes from that. I think the key thing for institutions is to ensure they put their clients at the heart of everything they do. I think where issues of mistrust come are when there are one-off, potentially, shorter-term relationships, rather than long term ones, where people start to question what the other party is trying to get out of it.

I agree, it is slightly overegged in the press, because I think it makes good reading. Some of these things are quite complex – if they're difficult to understand and people don't feel they've been given a full explanation, and sometimes it's because of complexity, that can lead to mistrust. I think institutions should try to be as transparent and understandable as possible.

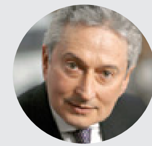
Walker-Buckton: In the institutional market, trustees do things. Trustees buy investment products, they change investment strategies, they work with advisers, they buy de-risking products. Those things wouldn't happen if there

THE PANEL

Chairman Jonathan Stapleton, editor-in-chief, Professional Pensions

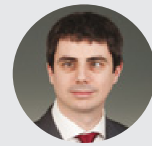


Mark Gull, head of fixed income & portfolio management, Pension Insurance Corporation



Robin Ellison, independent trustee and lawyer

Malcolm McLean, senior consultant, Barnett Waddingham



Tristan Walker-Buckton, actuary, Pension Insurance Corporation

wasn't trust in the market and trust in those providers. With the exception of a few fallings out and court cases where trustees and schemes have received poor advice, or received poor products, I think the relationships work very well.

I think where there is mistrust, it is more at the regulatory level. Before 2010, we were going through pension ministers the way Spinal Tap goes through drummers – and as soon as trustees felt that they were getting comfortable with the way pension schemes were being regulated, someone new would come in and they would have to change. If there is any mistrust, I would say that's where most of it lies.

McLean: I agree with pretty well everything that's been said up to now. We've had a drip drip series of bad news stories over the last 20 years and all of this gets into the minds of the public, who start believing that pensions are not to be trusted.

Also, there is this constant change. Ultimately, a lot of the things that we've done over the last 20 years have had to be unravelled. The minimum funding requirement, for example, proved to be a disaster. That had to be changed. We've done various U-turns. Tax allowances and tax relief are continually under review and we move from budgets to autumn statements wondering what's going to be the next change.

I think it is this constant change that creates uncertainty in everybody's mind and saps confidence in people's willingness to engage with pensions and to engage in trusting others who work within the industry.

Ellison: I agree with Malcolm 100% on his points about the incessant regulatory and government meddling, which really doesn't help at all. But there is one point which I think we're possibly overlooking, which is the difference between professional advice in services and non-professional advice.

"It is this constant change that creates uncertainty in everybody's mind and saps confidence in people's willingness to engage with pensions and to engage in trusting others who work within the industry"

Malcolm McLean, Barnett Waddingham

And I think there is a bit of a serious concern about the movement away from professionalism towards commercialism in services advice – and you can see it in some of the big consultancies.

I'm not going to name names, but there are firms where partners have tough internal targets and there is a bona fide suspicion that some of the advice that's been given is conflicted or it's not as independently minded as it ought to be.

We can see these sort of issues being reflected in the United States, with the imposition of fiduciary obligation on asset managers and on advisers – where they're supposed to have a duty to the client over and above the duty to themselves. And we're not quite seeing that in the UK.

Gull: I think most professionals actually have these issues in the front of their minds. I think, as Robin has highlighted, there are some instances where people set up a relationship that has conflicts, and that's when trust can be lost. But if you're an asset manager, and you've got a target return to make for the client, by serving the client well, you're making that return and you're incredibly focused and concerned about getting the performance right. That is a very simple and clear target you have for the client.

If there are things that muddy that view, I think that's where things can get complicated. And I think part of the problem we have – and it is down, in part to the point we touched on about regulation – is the increasing number of intermediaries we have in the system. This makes it difficult for people to understand how their pension is managed.

"Part of the problem we have – and it is down, in part to the point we touched on about regulation – is the increasing number of intermediaries we have in the system. This makes it difficult for people to understand how their pension is managed"

Mark Gull
Pension Insurance Corporation

Stapleton: Robin, earlier in this debate you made quite a controversial point – and, while everyone seems to be getting worked up about costs and transparency, you seem to take a much more relaxed view on this. Do you think that's a view people should be taking generally?

Ellison: Costs are clearly important and everybody can do the numbers showing the higher the costs, the lower the returns for the individual.

But I think there's an obsession with it at the moment and political capital is being made out of it.

The costs, while important, are, in my opinion, second order. I'm not too worried about the costs provided we're not being taken for a ride. What people make as a profit behind the scenes is nothing to do with me, it's a commercial operation. Provided they're giving me the service I need on the terms that are agreed, what the profitability

LOW
MEDIUM
HIGH

is behind the scenes is entirely a matter for them.

This obsession with taking everything apart is actually producing unintended consequences and sometimes the client is not getting the service that they really need because of price concerns.

There's also a big misunderstanding, in my opinion, between professional advice and commercial advice. Most people understand what's going on when they're taking advice. Where I do get concerned is where there's a perception of independent advice, when it is not independent. And I think there is beginning to be a degree of dissatisfaction in the pensions industry over the grey areas in between independence and professionalism.

Gull: The most important thing in my view is to make sure there are enough assets there to discharge the liabilities of the scheme and that members get paid. It's important we maintain the focus on that.

Yes, we should ask about costs, but Robin's point is well made – we shouldn't lose the focus on the big picture. If the necessary returns are being delivered to match the liabilities, people will trust the pension fund system because it is doing what it has promised its members to do. I think that is the most important thing.

Stapleton: Moving on to what makes the most trusted firms stand out? What do trusted businesses do that others do not do?

Walker-Buckton: So I'm an insurance salesman. But I'm trying to sell to trustees who are very well advised, who are briefed on the regulation underpinning my product, the way my product works, and all of that. I'm competing on a level with other insurers who are all regulated in the same way and the product is often largely the same.

For me, I think the insurers that build best relationships with their clients – and get more business from their clients – are those that think they are not selling a box of bonds, or mortgages or spreadsheets. These are pensioners at the end of the day. These are actual people. And those that can empathise with that do best with the trustees.

I've been in beauty parades where I'm trying to convince trustees to pick us relative to other insurers and we spend a good deal of time focusing on our financial strength and our governance and all those very important things. But quite often there are also trustees who will be concerned about things like members losing their annual lunch or the Christmas card they get every year should the scheme transfer to an insurance company.

That's something we really try and focus on. It reassures trustees to put things like customer service front and centre – we really do try and have a very good relationship and engage with our policy holders, make sure we're doing right by them and have their best interests at heart.

The legislation and regulation ensures a certain level of security that trustees can place their faith in, but the thing that can differentiate insurance companies is the level to which they engage with the pension scheme members.

Stapleton: Is engagement with members a key thing from your point of view Malcolm?

McLean: Absolutely. The one thing the industry has never been very good at is communication – communication in a language that the ordinary man and woman on the street can understand.

I think a lot more needs to be done as we're still riddled with jargon in many cases – and some of the letters I've seen that go out to members of the public have got to be incomprehensible to them. It is worth its weight in gold to put a lot of effort into improving your communications with your members, to let your members know exactly what's happening to them, what's happening to their pension, and to present a human face on the service that you give.

It is all about the continual level of service that you provide, and getting members to appreciate that service and to speak well of you among their colleagues and friends so that they know just how good this pension scheme is.

That is something that can only be built up over time and takes a lot of effort. You have got to work pretty hard at it and communication is the key to getting these messages across in a way that people can understand and appreciate.

"The insurers that build best relationships with their clients – and get more business from their clients – are those that think they are not selling a box of bonds, or mortgages or spreadsheets"

Tristan Walker-Buckton, Pension Insurance Corporation

It is worth its weight in gold to put a lot of effort into improving your communications with your members, to let your members know exactly what's happening to their pension, and to present a human face on the service that you give"

Malcolm McLean, Barnett Waddingham

Does the finance industry do a good job?

In a lecture in April, David Pitt-Watson outlined why he believes the finance industry needs reform. *PP* summarises his key arguments

No one can be in any doubt about the importance of the finance industry, particularly those who work within it. It is the "nervous system" of capitalism – if it fails, so does the economy. But few, even those who want to work in the industry, or who criticise it from the outside, have stepped back and asked "what is its purpose?" and "how well does it fulfil that role?".

In April, Pension Insurance Corporation hosted a lecture where London Business School executive fellow David Pitt-Watson outlined his thoughts on this issue and previewed his new book, *What they do with your money: How the financial system fails us and how to fix it*, which he has co-authored with Stephen Davis and Jon Lukomnik.

Pitt-Watson – the former head of Hermes' Focus Funds and the Hermes Equity Ownership Service – says to find out whether or not the finance industry is doing a good job, you have to start by asking what its purpose is in the first place.

He says such a question is easy to answer for most industries – noting, for instance, that the purpose of the drug industry is to cure you and the purpose of the food industry is to feed you and please your palate – but he says it is not quite as straightforward when you come to the finance industry.

Pitt-Watson explains: "We have looked back through all the academic literature and haven't found more than a few articles where people are thinking fundamentally about what the purpose of the finance industry might be, among the thousands and thousands that are published about finance every year."

The purpose of the industry

Fundamentally, Pitt-Watson believes the finance industry does four key things. First, he says, it keeps our money safe; second it helps us transact; third, it helps share our risk; and fourth, it intermediates, taking money from point A to point B, where it is needed.

Pitt-Watson says we now take it for granted that you can put your money in the bank and can be sure that it will be there the next day. But he notes there are many people around the world who don't have that privilege.

Take Haiti for example. Pitt-Watson says that people in Haiti don't, in general, have access to banks at all, with groups of friends getting together to pool their money every week as an alternative.

Pitt-Watson says Bangladesh is another example of why the

Biography: David Pitt-Watson

Every career is unique, but some are more unique than others. David Pitt-Watson possesses one of the latter type of careers. The co-author of *The New Capitalists*, Pitt-Watson co-founded Braxton Associates, eventually bought by Deloitte Consulting, and later became head of shareholder activist funds and director of Hermes Fund Managers, establishing Hermes as a leader in responsible investment.

He was author of a critical report into the UK pensions industry in 2012 and has advised politicians and policy makers – including prime ministers Tony Blair and Gordon Brown – and was assistant general secretary of the Labour Party.

Pitt-Watson graduated from Stanford University with an MBA in 1980 after studying Politics,

Philosophy and Economics at Queen's College, Oxford.

He left Stanford and entered the world of strategy consulting – co-founding and later becoming managing director of Braxton Associates. Braxton, where Pitt-Watson eventually spent 17 years, was later purchased by Deloitte and evolved into Deloitte Consulting, one of Europe's largest strategy consulting firms.

In 1999 Pitt-Watson joined Hermes Fund Managers as commercial director of its newly formed shareholder activist Focus Funds, which grew to be the largest of their kind in Europe. Pitt-Watson became head of the focus funds and a director of Hermes in 2004. He then established the Hermes Equity Ownership Service (HEOS), a service to pension funds which aims to ensure that the shares they own are used to promote good management practice and sustainable investment. HEOS now advises on over £150bn worth of assets.

Pitt-Watson left Hermes in 2012 and is currently an executive fellow at London Business School.

Source: London Business School

finance industry is so important for many people. He says Bangladesh now has a rule meaning that, in order to get a central bank licence, banks need to offer a 10 taka account, meaning people can open a current account or a deposit account with around 8 pence – an initiative that meant street children started depositing any money they were given into accounts to prevent it being stolen.

He says: "Keeping your money safe is absolutely fundamental."

Pitt-Watson believes the same is the case with regards to the ability to transact among ourselves. He says this is shown in places like Kenya, where people now transact through a service called M-Pesa, a mobile phone-based money transfer service which allows users to send money via text message.

Prior to that, Pitt-Watson says, migrant workers from one part of Kenya, would leave their village, go and work on a big farm, and their wages would come in an armed vehicle – leaving workers with the problem of how to send the cash back to their family several hundred miles away.

He says: "Now, you do it all on your telephone."

Pitt-Watson says the sharing of risk through the insurance industry means most of us no longer need to worry about the financial consequences of many of the catastrophes of life – so, if we have a pension, we can know that we are going to have an income until the day we die.

The fourth point Pitt-Watson raises – the one he believes is perhaps the very most important function of the finance industry – is intermediation.

He points out that, in concept, intermediation is very simple – paraphrasing Lord Rothschild saying it is all about taking money from point A, where it is, to point B, where it's needed, so that people can buy homes, businesses can buy assets and economies can grow.

Pitt-Watson explains: "These four services underpin a successful economy. Indeed, they underpin it to such an extent that if you search back through the history books, you actually discover that some of the pioneers of the industry are thought of not as being wealthy, slick individuals, but as clergymen."

"If you search back through the history books, you actually discover that some of the pioneers of the industry are thought of not as being wealthy, slick individuals, but as clergymen"

He says the first people's bank, the Trustee Savings Bank, was started by a Scottish minister in Dumfriesshire, who was considered a philanthropist. He says the first pension fund was also started in Scotland by another group of philanthropists.

And he cites a more modern day example of this philanthropy with the case of Muhammad Yunus, the Bangladeshi social entrepreneur who was awarded the Nobel Peace Prize for founding the Grameen Bank and pioneering the concepts of microcredit and microfinance – lending money to poor people so they could improve their lot.

Pitt-Watson says: "Yunus wasn't doing anything that was terribly different, technically, from what less savoury lenders do. He was lending money to poor people. But he was doing it in a way that had purpose and in that sense it was totally and completely different."

He adds: "So, have no doubt, finance absolutely has a purpose –safe custody, payment systems, intermediation, risk reduction. It's really fantastically important."

Doing a good job

This leads Pitt-Watson to his second question – does the finance industry do its job well?

He says if you were to ask that question to most people in this country, they would probably say no, because they would remember the financial crash of 2008 and they'll be saying that

something went terribly wrong there.

Pitt-Watson says the person who probably expressed this frustration as well as anybody was the Queen who, shortly after the crash, went to the London School of Economics and asked an assembled group of experts why didn't anyone see it coming and questioned whether things had got a bit lax.

But Pitt-Watson believes the answer to Her Majesty's question wasn't that things had got a bit lax but the people who were commenting on the system – the International Monetary Fund, for example – had got it completely wrong.

However, Pitt-Watson says financial crises are nothing new – and have been increasing rather than decreasing in number.

Yet, he says we shouldn't just look at how many financial crises there are but also, perhaps, how efficiently the finance industry provides its services.

He says one person has done a study to try and work this out – and cites the work of Thomas Philippon of New York University, who measured the cost of intermediation by dividing the income of the sector by the quantity of assets it has intermediated from and to the outside world over the past 130 or so years.

On average, Pitt-Watson says, there has been a tenfold increase in productivity across the US economy during this period – largely due to technological innovations including the telephone, computers and the internet. But in finance there was no increase in productivity whatsoever – no efficiency gain at all.

He says: "The cost of taking a dollar in 1880 and lending it out,

"We shouldn't just look at how many financial crises there are but also, perhaps, how efficiently the finance industry provides its services"

even on an adjusted basis, was exactly the same as it was in 2010."

Pitt-Watson adds: "So we have had no efficiency gain and we have had no avoidance of crises."

Where we go wrong

Pitt-Watson says that, while the finance industry has a profoundly important purpose, it doesn't look like it's fulfilling that purpose terribly well. And he believes there are two or three key areas we are getting wrong when it comes to finance.

He believes one issue is the way we study finance and the way it is approached by the academic world – saying there could be something missing in the way we are studying economics and finance, with people failing to understand the relationship between what it is they are studying and its purpose.

Pitt-Watson says: "As I look at much of what it is that is being taught, I think, in our business schools and in our economic faculties, there is the danger it has divorced itself from the reality of how someone can save for their pension; how we can keep people's money safe; how we can transfer money; and how is it that we can make sure we are investing in things that are going to give us a sustainable return and make sure people can pay their pensions."

He adds: "It is not because what we're teaching is wrong – this is not a criticism of the discipline itself – it is just that it is one-dimensional. It's like suggesting to a biochemist that it's okay for them to practice medicine. Biochemistry is important for medicine but it doesn't tell you the whole story. So we need to think a little bit about the way we teach."

Pitt-Watson also believes we need to think a lot about the way we regulate – noting that regulators particularly like to regulate in a single market, where

"As I look at much of what it is that is being taught, I think, in our business schools and in our economic faculties, it has divorced itself from the reality of how someone can save for their pension"

they decide how it is they can make that an open and competitive market and so on. That assumes an academic model where, if you have lots and lots of free markets, then it all ends up being great.

He explains: "The problem is that I don't think that's the way the world really works. And you have to be worried about something that people call the fallacy of composition. This is the belief that if you can see that one thing is right, then it will apply to all things taken together. The world is made of atoms – true. Atoms are invisible – true. The world is invisible – completely wrong.

"If we have one principle agent relationship that looks okay and another principle agent relationship that looks okay, and then 20 principle agent relationships that look okay, and 100,000 principle agent relationships that look okay, then we'll have a great pension system. I'm not sure that that is true. And until we start to regulate to purpose, I think we are always going to discover that we have this problem."

Pitt-Watson also speaks about individuals as practitioners – noting he finds the economics around the finance industry quite challenging.

He says: "I have spent most of my life in the finance industry and I thought I was doing a really great job. And now I find we have achieved absolutely no productivity improvement and we have created crises. What is it that we are supposed to do about this?"

Pitt-Watson says his new book offers some answers and believes that never losing sight of the purpose of finance is key – rather than just thinking about what it is possible to do.

"We need to construct markets so that they deliver for the ultimate consumer. There are literally scores of things we could do to promote that outcome. One simple thing; tell people how much it costs to run their investment funds.

"We could regulate, not with pages of legislation but to create institutions which do the right thing in the first place. We need to revive the notion of fiduciary duty. We should not abuse academic and other expertise, pretending that we can predict uncertainties. If we did these sort of things the payoff would be huge. In the book we show how a Dutch pension saver, who sets aside the same amount as someone from the UK or the USA will get a 50% higher pension, because the Dutch pension system is designed more closely to purpose."

Finally, he believes we must never forget that financial services are a human system – and one where, if we remembered that and thought more about purpose, we might get to a place where the system starts to work considerably better.

Pitt-Watson concludes by saying the vital role of the finance industry means we need to solve the challenges it faces.

He says: "I can't think of any challenges of the 21st century that are solvable without the financial services industry. How do we take a billion people out of poverty? How do we develop infrastructure and technology to make human life sustainable on earth? How do we promote incomes so that people don't run out of money in their old age? How do we share the risks of health or ageing or human or natural disaster?

"At the heart of the answer to all those questions is our industry: the financial services industry."

"We have achieved absolutely no productivity improvement and we have created crises. What is it that we are supposed to do about this?"

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