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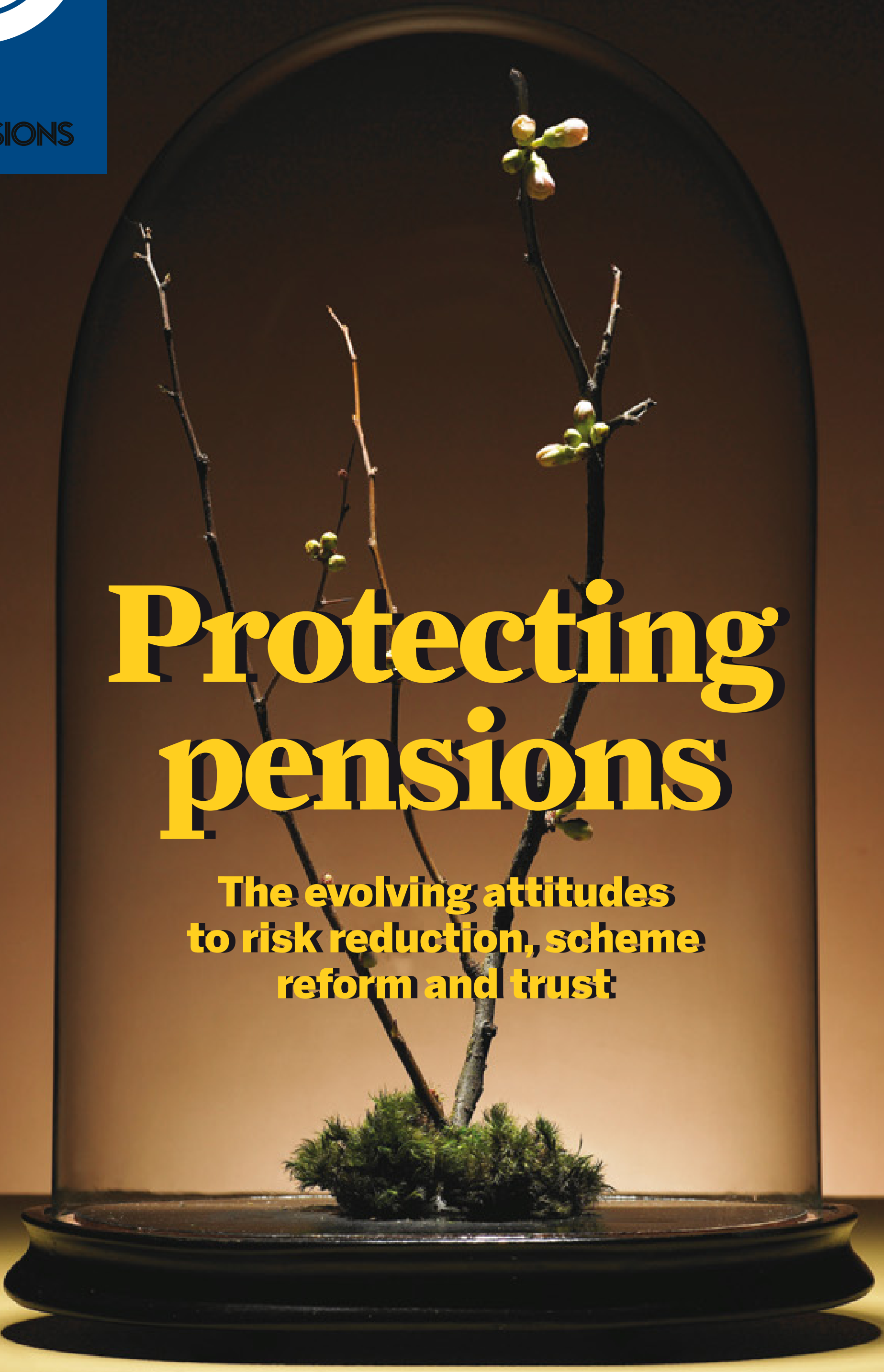

Protecting pensions

The evolving attitudes to risk reduction, scheme reform and trust

PENSION INSURANCE CORPORATION

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Schemes embrace de-risking to meet the challenges

The EU Referendum on 23 June last year was followed by the election of Donald Trump as US president in November and a UK General Election in June 2017, which led to a hung parliament.

These changes have led to further uncertainty in financial markets – with large falls in the value of sterling against both the dollar and the euro, volatility in bond markets and record equity market highs.

Perhaps as a result of some of this uncertainty, aggregate pension scheme deficits have risen significantly – rising from around £188.7bn at the end of April 2016 to £245.6bn at the end of April 2017 on an s179 basis.

In addition to this, pension schemes have also had to face potential changes in the regulatory environment – and, over the past year, we have had reports from the Work and Pensions Committee (WPC) and The Pensions and Lifetime Savings Association's DB Pensions Task Force as well as a green paper on pensions.

Yet, despite this volatility, the increases in deficits and the possibility of changes to the regulatory environment, the appetite to de-risk schemes and move to a more sustainable and predictable footing has never been greater.

This supplement presents the results of exclusive research *Professional Pensions* has conducted in association with Pension Insurance Corporation.

The research, which is now in its second year, reveals schemes are largely continuing with their plans to de-risk – using an ever wider range of strategies in order to take risk off the table.

This supplement also looks at how two pension schemes conducted major buy-ins over the past 18 months – looking at how the Pilkington Superannuation Scheme completed a £230m deal and assessing how the Aon Retirement Plan conducted a £900m transaction.

We also take an in-depth look at investing in social and affordable housing; speak to a panel of four independent trustees, asking them for their views on risk reduction market; and hold a Q+A on the future of DB.

Finally, earlier this year, Pension Insurance Corporation facilitated a lecture from David Pitt-Watson and Dr Hari Mann as part of its Purpose of Finance project. 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*

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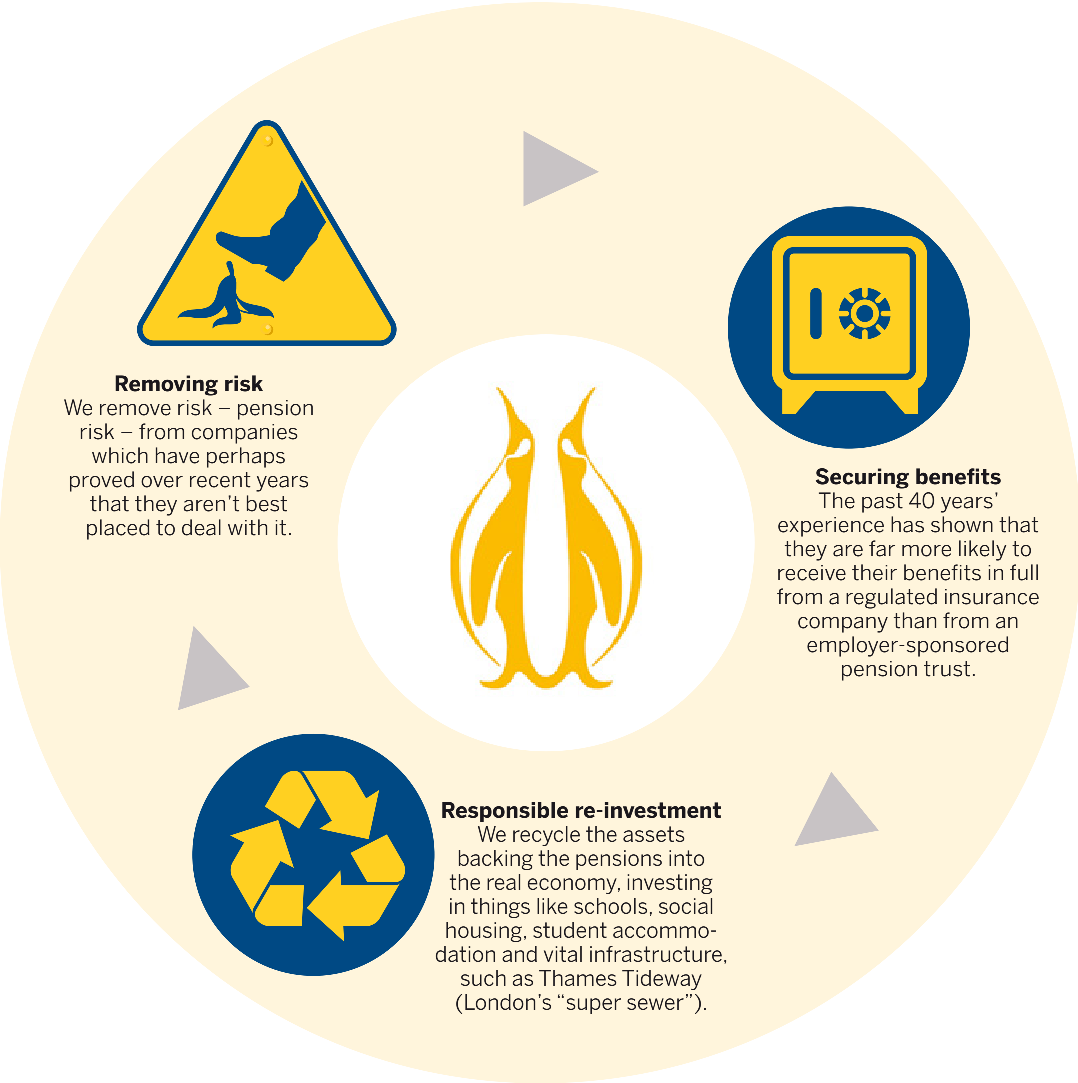
About Pension Insurance Corporation

The purpose of PIC, as a specialist insurance company, is to pay the pensions of our 135,000 policyholders.

To do so we have a portfolio of about £23 billion of assets backing those pensions. This portfolio has been accumulated, since 2008, by consolidating more than 130 UK defined benefit pension schemes through the provision of bulk annuities – pension insurance buyouts and buy-ins – to the trustees and sponsors of those schemes.

Our pension fund clients include the London Stock Exchange, Philips, Cadbury, Honda, the Institute & Faculty of Actuaries, and the National Association of Pension Funds (now the PLSA).

How PIC benefits individuals and the economy



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Forward thinking

Jonathan Stapleton looks at the outlook for risk reduction and assesses the trends we can expect to see over the coming year

Full-year volumes for pension buy-ins and buyouts in 2016 by UK pension plans totalled £10.2bn – marking the third year in a row that volumes have exceeded £10bn. LCP's analysis of insurer data for 2016 found the majority of these deals – around £7.5bn – completed in the second half of 2016, highlighting the surge in activity following the EU referendum.

And the consultant said there were a record 24 transactions over £100m (2015: 19; 2014: 21) during the year – demonstrating that appetite from pension plans remained high.

LCP said there were also four longevity swaps during 2016, totalling £2.6bn.

Commenting on the activity for 2016, LCP partner Charlie Finch explained the firm saw an acceleration of de-risking activity by pension plans following the EU referendum driven by both an increased desire to lock down pension risks and attractive pensioner buy-in pricing.

2017 and beyond

Mercer partner Martyn Phillips says that, while the 2016 was a strong year for bulk annuity deals, the total amount transacted was down on 2015 – something he put down to uncertainties around the EU referendum and the US election as well as a "post-Solvency II hangover", where lots of deals were drawn into 2015 to "get across the line" before the implementation of the insurance directive at the start of 2016 (*see: What is Solvency II?, page 8*).

He says: "An easy decision for any trustee board and sponsor to make has been to do nothing and we saw a lot of that last year.

"But you can only hold back the demand for so long – there has been ever-increasing demand, subject to getting the right price in the market, and, given the low levels of activity last year, we have started to see a surge of activity this year."

Phillips adds: "I would liken it to a swan at the moment in as much as what we have seen above the water so far this year looks like it has been just a steady progression of trades and de-risking deals but I think the reality is, behind the scenes – under the water, to use the swan analogy – there is a lot more going on and we certainly anticipate a flurry of transactions over the rest of 2017.

"An easy decision for any trustee board and sponsor to make has been to do nothing and we saw a lot of that last year"
Martyn Phillips

Indeed, consultants believe that 2017 could be a record year for bulk annuity transactions – especially if some larger deals complete.

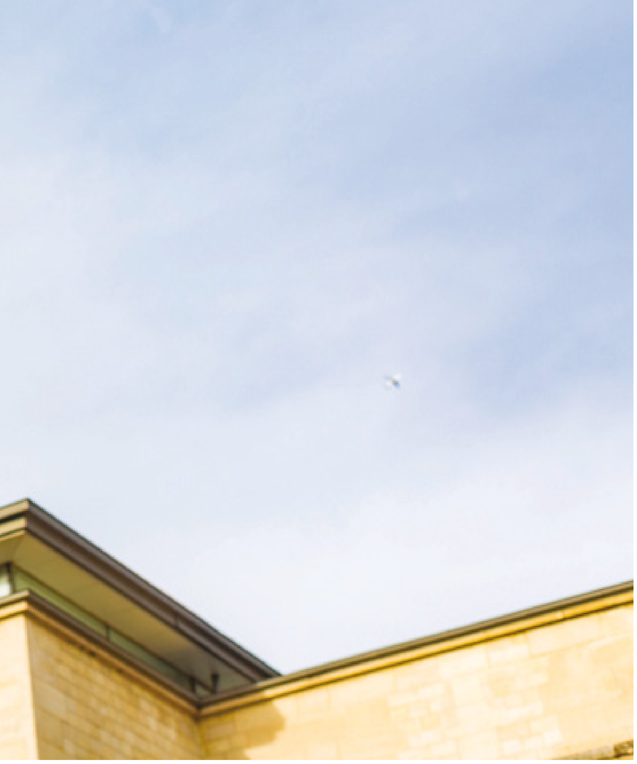
LCP's Finch says that there has been quite a lot of volume in the bulk annuities market so far this year, especially in the mid-size transaction space.

He says: "Whether or not we hit the £15bn prediction we made at the end of 2016 depends on how many of the £1bn-plus transactions complete this year."

Pension Insurance Corporation (PIC) head of strategic development David Collinson agrees: "We're seeing reasonable levels of volume going through the market, we've a very healthy pipeline. So we would be aligned with the predictions that we're going to see very healthy volumes in the market over the next 12 to 18 months.

"It has the potential to deliver between £10bn and £20bn of transactions but whether or not that headline volume is hit or not depends on how many large deals happen, which can be a bit binary."

Collinson believes however that these



transactions will be very much focussed on buy-ins – particularly in the light uncertainty around interest rates.

He explains: "Buy-ins are going to be the drivers of volume in the market and I'd expect to see more large funds following the path initially trod by ICI, where they do a series of buy-ins with potentially different providers (*see: Eight reasons to adopt a tranched buy-in strategy, page 9*).

"If you've already insured with two or three insurers, you're very well placed to move quickly when market conditions work in your favour."

Challenges

Mercer's Philips also believes there could be a record year but says capacity could become an issue as more schemes come to market – with insurers potentially needing to prioritise the completion of transactions over schemes coming to the market looking for quotes as demand increases.

He says: "Part of the challenge for the marketplace, as it has always been, is that capacity among the insurers to engage with pension schemes, particularly when lots of pension schemes are looking to trade, is limited."

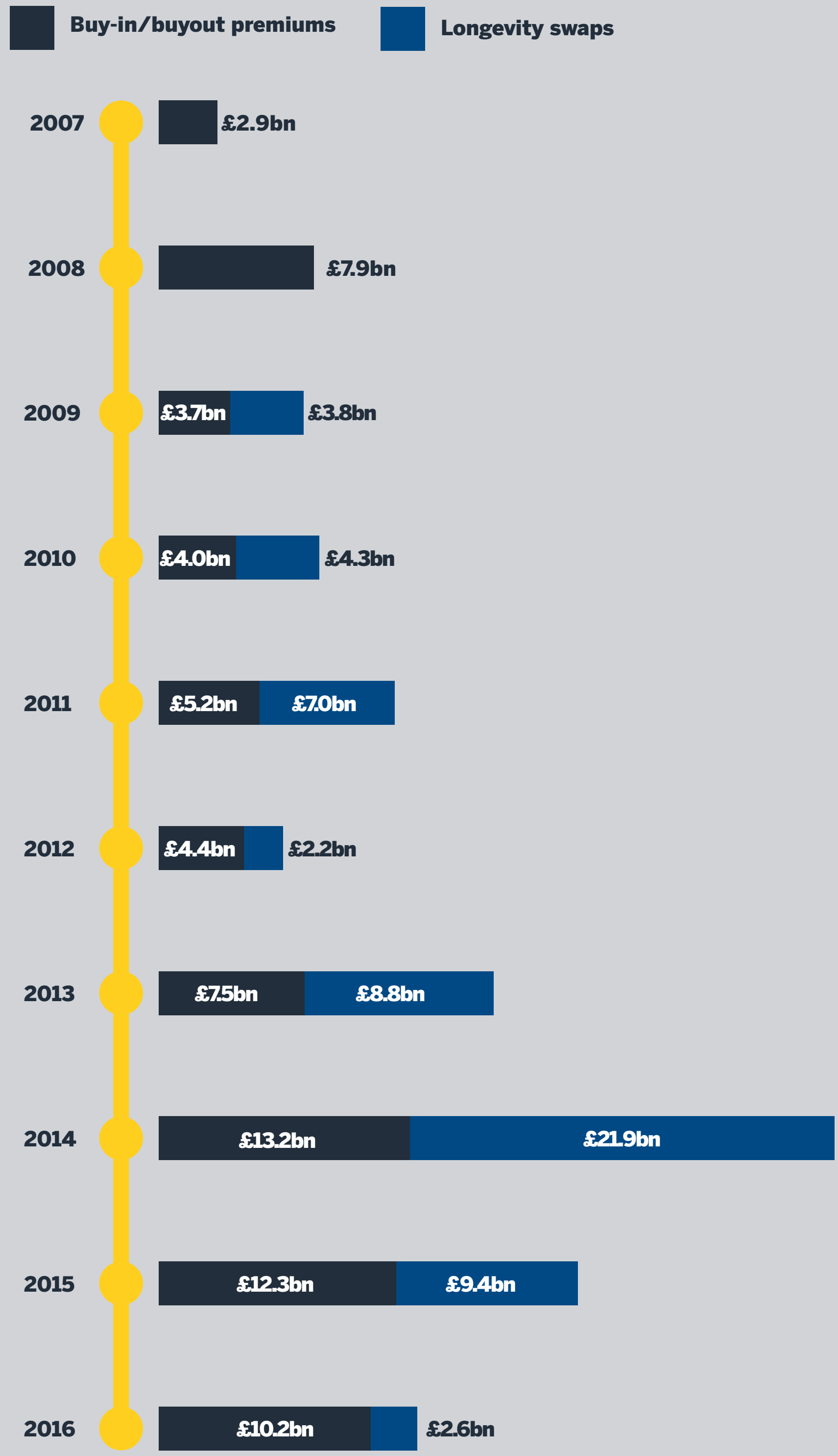
Philips adds: "It creates a challenging dynamic to ensure client expectations are appropriately managed."

Schemes will, Philips says, also have to do more work before going to market to show they are serious about conducting a deal.

He says: "You don't necessarily have to be 100% there on data, but what you need to be able to do is show insurers that you have been through an appropriate process to think about the transaction; appropriate engagement has happened between trustees and sponsor; there is a realistic view from the trustees and sponsor as to what the cost might be if there is additional cash required from the sponsor to do the deal; and that their data meets a certain minimum quality standard.

How the de-risking market has evolved

Insurance activity (2007-2016)



Source: LCP Pensions De-risking Report 2016

> **"Research suggests that, on average, schemes are about 85% funded on a technical provisions basis but on a buyout basis, it will be far lower than that, 60-70%, so there is quite a big gap"**
> **Donny Hay**

"You absolutely need to demonstrate that you have lined everything up in terms of considering and planning for any de-risking process. And that has become even more important right now."

PS Independent Trustees managing director Wayne Phelan adds: "Making sure your data is in good order and making sure you know exactly what benefits you are going to secure tends to lead to having a good benefits specification available to then take to the insurers, something which shows that you are not only serious about a transaction but also makes sure you are valuing the right liabilities.

PIC's Collinson agrees – noting that time spent understanding what a scheme's de-risking options are and understanding views on risk and return is also an important step.

He says: "Having this understanding will enable you to decide what you think value for money is and whether you believe, for example, insurance contracts are value for money compared to the alternatives. Because you need to have that mindset and to have decided what represents value for money and when do you think insurance is cheap or when you think it is expensive compared to other options."

At the same time as this, Collinson says trustee boards should also be engaging with the sponsoring employer, getting them to buy into any decisions and understand that value proposition.

Collinson explains: "Our experience is that transactions are generally only successful, particularly the bulk annuity transactions that we do, if both the sponsor and the trustees are actively involved, engaged and supportive of the transaction."

He adds: "With most of the large transactions we've worked on, it has been a joint project with the sponsor and the trustees – and both have been supportive of the transaction."

Affordability

Yet, no matter how much preparation schemes are currently doing, there is still a significant problem with affordability as many schemes still have large funding challenges.

PTL client director Donny Hay explains: "Some schemes are close to buy-in, few to buyout.

"Research suggests that, on average, schemes are about 85% funded on a technical provisions basis but on a buyout basis, it will be far lower than that, 60-70%, so there is quite a big gap."

2020 Trustees associate director Samiea Ashraf agrees – saying that while a small number of schemes are looking at buyout, affordability issues mean it is a challenge for many.

She says: "Given current insurance pricing, buyout does remain a much longer term objective for bulk of our schemes. The cost of buyout can be significant for sponsors and given the current economic uncertainty most are conserving cash to use to fund future growth initiatives."

Ashraf adds: "An additional barrier is the premium charged for insuring deferred members who have some time until retirement. Deferred premiums appear to have been hit particularly hard by Solvency II and this has moved some of our monitored schemes much further away from transacting."

PS Independent Trustees' Phelan adds: "Funding really is the main driver of whether people are looking at insurance-based solutions or not."

Member options

However, while not all schemes may currently be in a position to complete a bulk annuity transaction, a significant number are looking at member options and liability management exercises to help move liabilities off balance sheet or reshape liabilities in order for future bulk annuity transactions to be more cost effective.

Writing in Aon Hewitt's Risk Settlement Market Report 2017, partner John Baines explains: "Getting your scheme ready for a potential bulk annuity is now much more than a data cleanse. Material savings can be made by restructuring benefits and offering members an option."

Baines cites three examples of such member option exercises – pension increase exchanges, where members are offered the option to exchange pension increases for a higher non-increasing pension or the same pension with fixed increases; transfer value options, where schemes take pro-active steps to help members understand the transfers available; and trivial commutation, where

What is Solvency II?

Solvency II is the risk-based regulatory regime that came into force on 1 January 2016. LCP says it sets a framework for determining how much capital insurers have to hold to back their liabilities.

The consultant says that, to price buy-ins and buy-outs economically, insurers are now required to closely match their liability and asset cashflows in line with strict rules for 'matching adjustment' eligibility – and warns that falling outside the rules can make a buy-in or buyout and uneconomic due to additional capital requirements.

LCP says insurer pricing for pensioners has been largely unchanged, where it is straightforward for insurers to match their asset and liability cashflows.

However it says longer-dated non-pensioner liabilities have been more challenging, noting that, while pricing varied during 2016 as insurers got to grips with the new rules, these challenges have been largely resolved.

LCP says that, post-Solvency II, there has also been an increased appetite from insurers to source assets with stable, long-term cashflows.

Source: LCP Pensions De-risking Report 2016

Eight reasons to adopt a tranched buy-in strategy

Increasingly, the annuity market is becoming dominated by schemes securing their liabilities in phases, as it becomes affordable. Aon Hewitt partner Paul Belok explains the advantages of the tranche approach, compared with the apparent efficiency of one final annuity to secure everyone.

1. First annuity gives conviction
It establishes the trustees' comfort with the market, the criteria for deciding to purchase annuities, and also the framework for choosing the insurer and the benefits to secure. It also establishes the scheme's credentials with the market as a serious purchaser.

2. Make the most of annuity provider preferences
As providers' target markets differ, it is possible to choose a tranche that represents the profile preferred by a particular segment of the market. An example is the securing of larger pensions with a provider who likes to price these benefits accurately using medical information.

3. Optimal market pricing
For many schemes, the full scheme would represent a large transaction which some bidders may struggle to absorb. Competitive pressure is maximised by placing in tranches.

4. Restrict financial impact
Avoiding a material adverse impact on funding, corporate accounting, cash or expected returns can be key criteria for de-risking. The acceptable parameters can determine the affordable size of the next transaction.

5. Synergy with investment strategy
As schemes mature, they will gradually hold more low-risk assets that can easily be exchanged for an annuity without impacting the overall investment objectives of the scheme. These include maintaining the hedging strategy for benefits not secured. The tranche approach can make more efficient use of assets as soon as they can be freed up.

6. Data cleansing
The annuity programme may be tailored to gradually secure different sections of the scheme once the benefit entitlements in them are fully cleansed and finalised.

7. Restrict hedging costs
For some liabilities, the cost of securing them will decline over time to a more digestible amount. This could entail avoiding meeting the cost of hedging some more expensive inflationary pension increase terms until the members are older.

8. Easier decision-making
It is simpler to make decisions with a smaller impact. A single big annuity purchase needs more thinking time and consultation, which could mean missed market opportunities.

Source: Aon Hewitt Risk Settlement Market Report 2017

"The challenge we face as trustees is ensuring members are presented with complete and accurate facts, that the appropriate advice is available and that the relevant guidance has been followed"
Adrian Kennett

members with small pensions are offered a cash lump sum alternative.

2020 Trustees' Ashraf says such exercises are now becoming standard discussion items across schemes. She says: "Liability management exercises remain a standing agenda item across all our schemes and are in various stages of completion.

"We accept there is a potential selection risk created in running liability management exercises as a pre-cursor to buyout however at present this is a risk we are prepared to accept as part of the overall de-risking framework."

PTL's Hay adds that another key trend will be for schemes to automatically quote transfer values at retirement or when people ask about pensionable salary.

He says: "Providing transfer value quotes is something a lot of schemes have been considering. Take-up of these quotes can be in the high single digits in some cases – and it is often popular among higher paid employees with other arrangements elsewhere. I think this trend will continue."

But despite the advantages of conducting such exercises, there are challenges for trustees to overcome. Dalriada Trustees director Adrian Kennett explains: "As with all liability management exercises, the challenge we face as trustees is ensuring that members are presented with complete and accurate facts, that the appropriate advice is available and that the relevant guidance has been followed.

"DB pension schemes can be complex beasts – the issues which members are being presented with are correspondingly complex. Those issues need to be explained in a fair and transparent manner."

Future growth

Mercer's Philips concludes that, ultimately, the growth of risk reduction will be fuelled by the underlying dynamics of private sector DB schemes – with most now being closed to both new entrants and future accrual and maturing at a rapid pace.

He concludes: "If trustees wind the clock forward and look at what their scheme will look like, they are very aware now that in ten years' time they could have up to 90%, 95% pensions in payment. "At that point, it becomes a very different beast in terms of the risk you are trying to manage. And that changes the focus in terms of where trustees and sponsors want to go around managing risk."

Evolving attitude to risk reduction, trust and scheme reform

Jonathan Stapleton takes a look at the results of *Professional Pensions'* 2017 survey on risk reduction, pension reform and trust in scheme advisers and providers

At a glance

- 152 UK trustees and pension professionals took part in the poll
- 55% of those surveyed expect to reduce risk over the coming 24 months
- Trust remains vitally important when it comes to choosing advisers and providers

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) earlier this year.

This is the second year *PP* has conducted this study, but a huge amount has happened in the intervening period, including a vote for Brexit and a general election.

The response rate to this year's survey was slightly higher, with some 152 UK trustees and pension professionals taking part in the study. Around half (52%) of respondents described themselves as trustee, 27% were pension scheme managers and 6% were finance directors. The remainder of respondents' occupations (15%) included consultants and advisers as well as those with other scheme roles.

Some 48% of respondents came from DB schemes that were closed to all future accrual, 31% came from schemes closed to new members and 9% came from schemes that were still open to new members. The remaining 12% came from a range of hybrid schemes and from schemes with both open and closed sections.

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

Just under a quarter (24%) of those who responded to the survey had technical provisions of more than £1bn; a further 19% of schemes had technical provisions of between £250m and £1bn; and 10% had provisions of between £100m and £250m. A further 47% had technical provisions of up to £100m.

Of those schemes with technical provisions of between £250m and £1bn, 47% had provisions of between £250m and £500m; 42% had technical provisions of between £500m and £750m; and 11% had provisions of between £750m and £1bn.

And, of those schemes with technical provisions of up to £100m, 51% had provisions of less than £25m; 26% had technical provisions of between £25m and £50m; 15% had provisions of between £50m and £75m and 8% had provisions of between £75m and £100m.

RISK REDUCTION

The first part of our research looked at risk reduction. According to our research, some 55% of respondents said they expected their scheme to reduce risk over the coming 24 months – five percentage points lower than last year, when 60% said they were expecting to reduce risk over the coming 24 months. A further 38% (2016: 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, the same proportion as in the 2016 study.

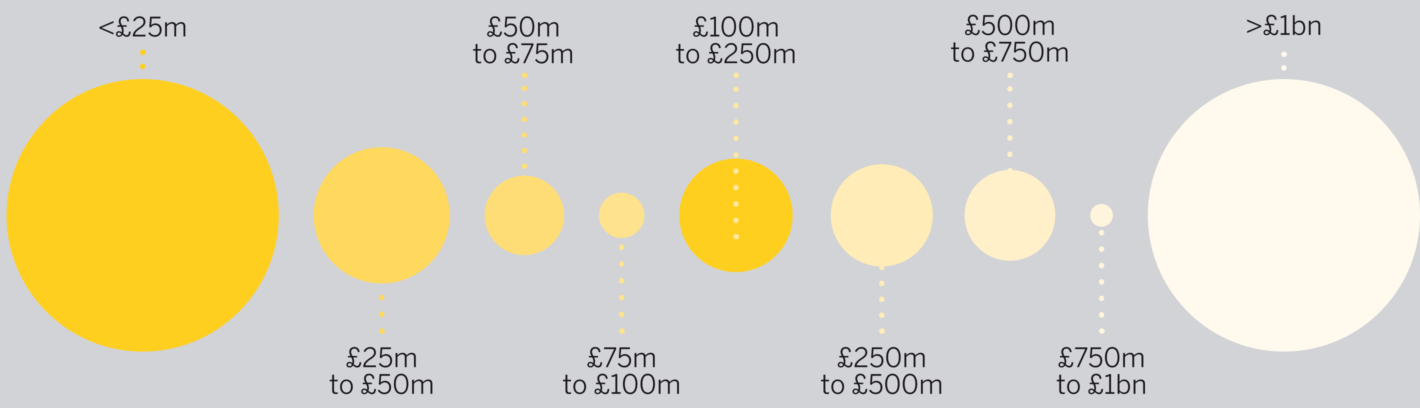
However, the survey found willingness to de-risk changes markedly with scheme size – with larger schemes much more likely to derisk over the coming 24 months.

Among those schemes with technical provisions of more than £1bn, 69.4% said they expected to de-risk over the coming 24 months – with just 19.4% of respondents from schemes in this size range saying they planned to make no changes and 11.2% saying they would increase risk in order to target higher returns.

This was roughly the same among schemes with technical provisions of between £250m and £1bn – where 57.1% of respondents said they expected their scheme to de-risk over the next two years against 35.7% who expected to make no change and just 7.2% that expected to increase risk.

Of those schemes with technical provisions of £100m to £250m, 53.3% of respondents expected to reduce risk in the coming 24 months, 46.7%

What are the technical provisons of your scheme?



intended to make no change and 0% intended to increase risk.

Smaller schemes – those with technical provisions of up to 100m – were the least likely to de-risk over the coming 24 months, with just 46.5% expecting to de-risk over the coming two years. The same proportion (46.5%) said they intended to make no change and 7% said they would increase risk.

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.

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, 51% said their scheme had increased the proportion of close matching assets. A further 27% said they were currently implementing such a shift and 9% said they were planning to implement such a strategy.

But, while this option was the most implemented across all scheme sizes, the very smallest schemes tended to have made less progress towards this goal than their larger peers – with just 39% (2016: 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 86% (2016: 45%) of respondents from schemes with technical provisions between £100m and £250m, 44% (2016: 52%) of respondents from schemes with provisions of £250m to £1bn and 58% (2016: 64%) of respondents in schemes with technical provisions in excess of £1bn.

Current de-risking position

7%
Intend to increase risk to target higher returns

38%
Expect to make no changes in the next 24 months

55%
Expect to reduce risk in the next 24 months

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, 33% said their scheme had increased these hedging ratios. A further 23% said they were currently implementing such an increase and 15% said they were planning such a rise in hedging.

Interestingly, there has been a significant rise in the proportion of schemes that have already implemented an increase in hedging ratios, with only 24% saying they had done so in last year's survey.

Once again, larger schemes were more advanced with implementing this option than smaller schemes – with the proportion of the very largest schemes putting such an option in place nearly doubling since last year.

Just 13% (2016: 6%) of respondents from schemes with technical provisions of less than £100m said their scheme had increased hedging compared to 38% (2016: 18%) of respondents from schemes with technical provisions between £100m and £250m, 27% (2016: 28%) of respondents from schemes with provisions of £250m to £1bn and 62% (2016: 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 – and there was a sharp rise in the numbers of respondents currently implementing this option.

Among those respondents expecting to de-risk over the coming two years, 21% said their scheme had implemented such a shift towards alternatives or more illiquid assets. A further 26% (2016: 16%) said they were currently implementing such a strategy and 13% (2016: 9%) said they were planning to implement such a strategy.

There was a wide difference here between the approach of larger schemes and the very smallest, but there has been a significant increase in the number of smaller schemes adopting this strategy over the past year.

Some 13% (2016: 0%) of respondents from schemes with technical provisions of less than £100m said their schemes had implemented a strategy to increase returns through alternatives, and 23% said they were currently implementing such a strategy. Some 38% (2016: 9%) of respondents from schemes with technical provisions between £100m and £250m had implemented a more alternatives-based investment strategy along with 20% (2016: 19%) of respondents from schemes with provisions of £250m to £1bn and 28% (2016: 57%) of respondents in schemes with technical provisions in excess of £1bn.

Managing liabilities

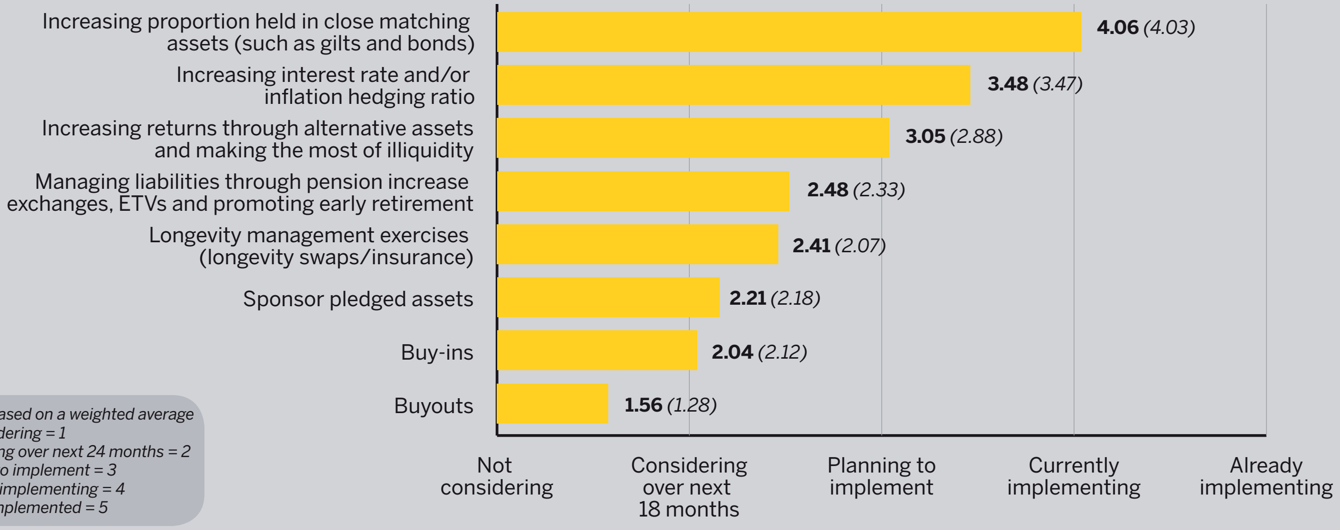
Managing liabilities through PIEs, ETVs and promoting early retirement were less popular options for respondents as a whole but it is clear that, when compared to the results from last year's survey, these options are becoming more appealing.

Among those respondents expecting to de-risk over the coming two years, some 13% (2016: 7%) said their scheme had used these sorts of exercises to reduce risk. But this could change rapidly in the future as a further 15% (2016: 21%) said they were currently implementing such a strategy and 13% (2016: 7%) said they were planning to conduct such an exercise.

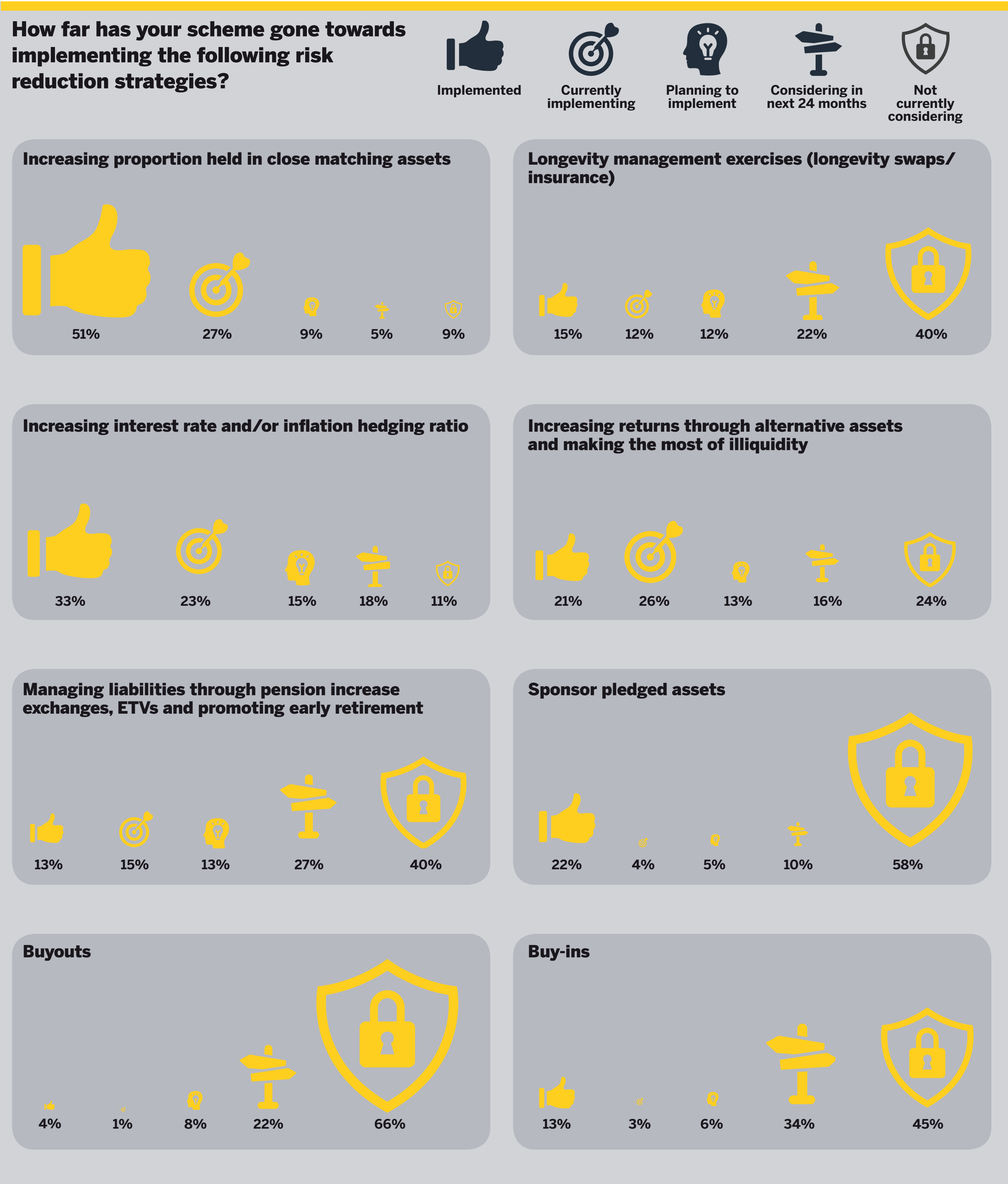
Once again, larger schemes tended to be more advanced in their implementation of these sorts of exercises than their smaller peers, but there had

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

(2016 figure in brackets)



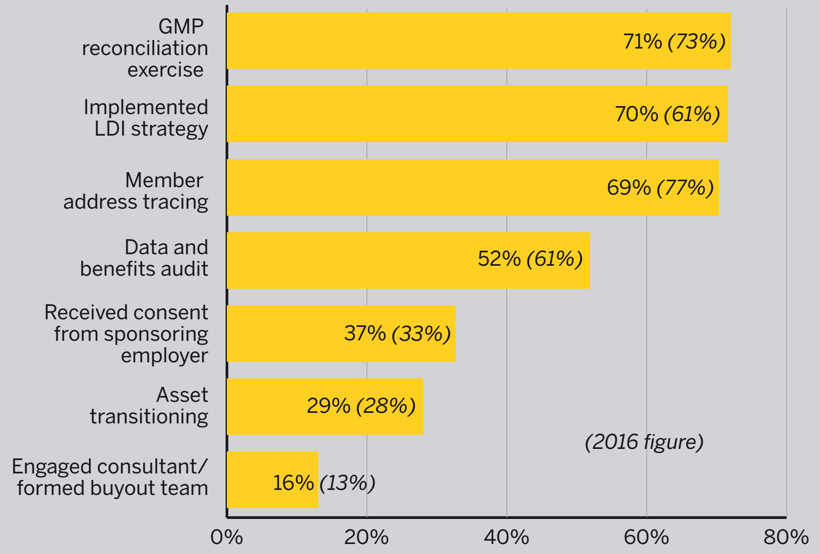
Score is based on a weighted average
Not considering = 1
Considering over next 24 months = 2
Planning to implement = 3
Currently implementing = 4
Already implemented = 5


How far has your scheme gone towards implementing the following risk reduction strategies?
Implemented
Currently implementing
Planning to implement
Considering in next 24 months
Not currently considering
Increasing proportion held in close matching assets
51%
27%
9%
5%
9%
Longevity management exercises (longevity swaps/insurance)
15%
12%
12%
22%
40%
Increasing interest rate and/or inflation hedging ratio
33%
23%
15%
18%
11%
Increasing returns through alternative assets and making the most of illiquidity
21%
26%
13%
16%
24%
Managing liabilities through pension increase exchanges, ETVs and promoting early retirement
13%
15%
13%
27%
40%
Sponsor pledged assets
22%
4%
5%
10%
58%
Buyouts
4%
1%
8%
22%
66%
Buy-ins
13%
3%
6%
34%
45%

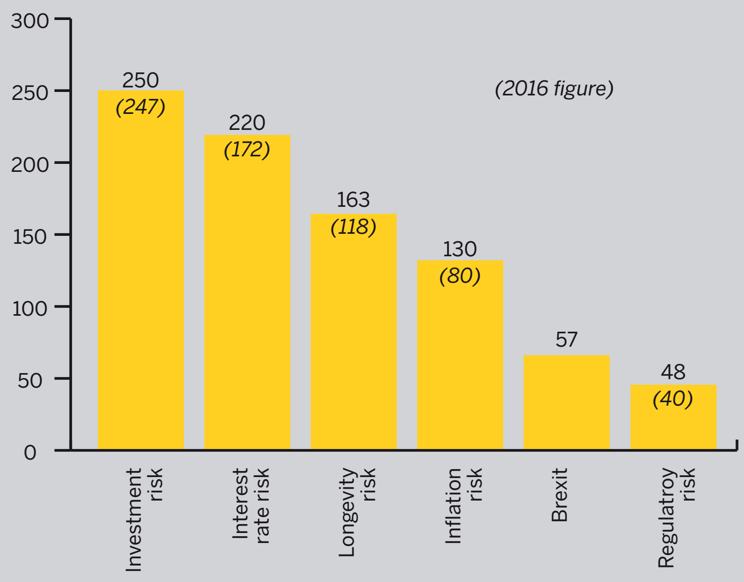
been significant growth in the use of such strategies among medium-sized schemes.

Some 3% (2016: 7%) of respondents from schemes with technical provisions of less than £100m said they had implemented such exercises compared to 14% (2016: 0%) of respondents from schemes with technical provisions between £100m and £250m, 31% (2016: 11%) of respondents from schemes with provisions of £250m to £1bn and 13% (2016: 14%) 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?



Which are the biggest risks facing your pension scheme currently?



Sponsor pledged assets

As last year, 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, 22% (2016: 23%) said their scheme had used such a strategy.

A further 4% 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 43% (2016: 26%) of schemes with technical provisions in excess of £1bn, 13% (2016: 25%) of schemes with technical provisions of between £250m and £1bn and 14% (2016: 27%) of schemes with provisions of between £100m and £250m using such options, compared to just 13% (2016: 13%) of schemes with provisions of less than £100m.

Buy-ins

Buy-ins were a reasonably popular form of risk reduction among respondents, with the numbers of respondents currently using them and planning to use these strategies remaining broadly similar to last year.

Among those respondents expecting to de-risk over the coming two years, 13% said their scheme had implemented a buy-in. A further 3% said they were currently implementing a buy-in, 6% said they were already planning a buy-in, and 34% said they would consider such a move over the next 24 months.

Buy-ins had roughly equal popularity among smaller to medium sized schemes but were significantly more popular among the largest schemes. Some 17% (2016: 21%) of schemes with technical provisions in excess of £1bn said their scheme had implemented a buy-in and 31% of respondents from schemes with provisions of £250m to £1bn had done likewise, a significant rise from the 10% of respondents who answered in the same way last year.

Just 14% of schemes with technical provisions between £100m and £250m and 0% of respondents from schemes with technical provisions of less than £100m said they had implemented a buy-in.

Longevity management

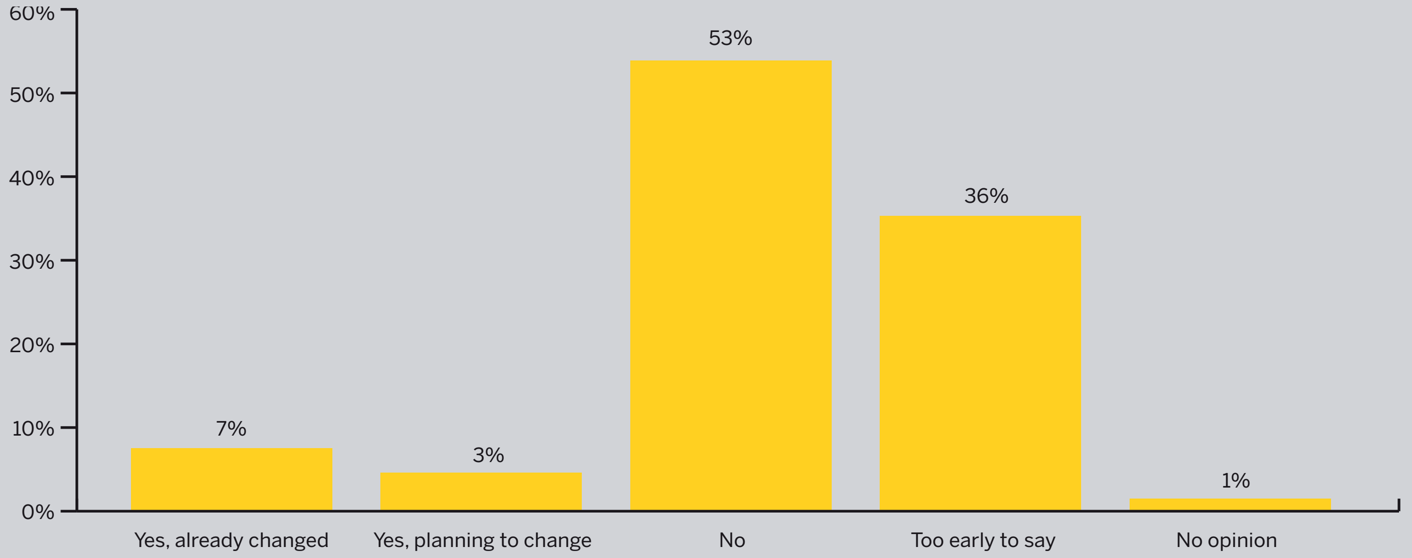
Among those respondents expecting to de-risk over the coming two years, just 15% (2016: 13%) had conducted longevity management exercises such as longevity swaps or insurance.

However there has been a sharp increase in the proportion of schemes saying they are currently implementing a longevity management exercise with 12% of respondents saying they are currently implementing, against just 4% in last year's study.

A further 12% (2016: 6%) said they were planning one, and 22% (2016: 30%) said they were likely to consider such a move over the next 24 months.

Once again, longevity management exercises had significantly more popularity among larger

Have you changed or are you planning to change your investment strategy following last year's EU referendum?



schemes – with just 3% (2016: 0%) of respondents from schemes with technical provisions of less than £100m saying their scheme had implemented such an exercise, compared to 14% (2016: 18%) of schemes with technical provisions between £100m and £250m, 20% (2016: 10%) of respondents from schemes with provisions of £250m to £1bn and 25% (2016: 24%) of respondents in schemes with technical provisions in excess of £1bn.

Buyouts

While, unsurprisingly perhaps, there were only 4% of respondents to the survey that said one of their schemes 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, 8% said they were already planning to implement one and 22% said they were considering such a move over the next 24 months.

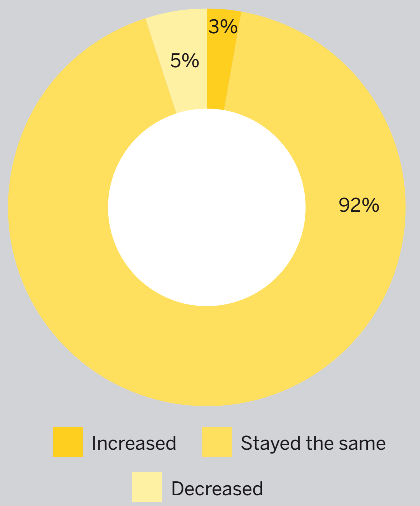
Respondents from those schemes with provisions of between £100m and £250m tended to find the buyout option far more appealing than other groups – with 71% of respondents in this group either currently implementing, planning to implement or considering a buyout. This compares to 29% of schemes with technical provisions in excess of £1bn, 33% of schemes with provisions of £250m to £1bn and 28% of smaller schemes with provisions of £100m or less.

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.

The findings were similar to the 2016 survey, with some 71% (2016: 73%) of respondents saying their scheme had conducted a GMP reconciliation exercise; 70% (2016: 61%) reporting they had implemented an LDI strategy; 69% (2016: 77%) saying their scheme had conducted a member address tracing exercise; and 52% (2016: 61%) saying they had completed a data and benefits audit.

Has your trust in pension scheme providers and consultants increased over the past 12 months?



Overall level of trust in pension scheme providers and consultants

Highest

10	7.7%
9	21.8%
8	32.4%
7	19.0%
6	11.3%
5	4.2%
4	1.4%
3	1.4%
2	0.7%
1	0%

Lowest

In addition, 37% had received consent from their sponsoring employer, 29% had conducted some asset transitioning and 16% 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 49% of respondents from schemes with technical provisions of less than £100m had conducted GMP reconciliation exercises, compared to 83% of schemes with technical provisions between £100m and £250m, 94% of schemes with technical provisions of £250m to £1bn and 92% of schemes with technical provisions in excess of £1bn.

There was a similar pattern elsewhere, with just 55% of respondents from schemes with technical provisions of less than £100m having implemented an LDI strategy, compared to 100% of schemes with technical provisions between £100m and £250m, 75% of respondents from schemes with technical provisions of £250m to £1bn and 88% of respondents in schemes with technical provisions in excess of £1bn.

And just 55% of respondents from schemes with technical provisions of less than £100m had conducted a member address tracing exercise, compared to 83% of schemes with technical provisions between £100m and £250m, 88% of respondents from schemes with technical provisions of £250m to £1bn and 79% of respondents in schemes with technical provisions in excess of £1bn.

Risks facing schemes

The final questions we asked respondents were 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 250 (2016: 247); followed by interest rate risk, with a score of 220 (2016: 172); longevity risk,

What makes the most trustworthy firms worthy of that trust?

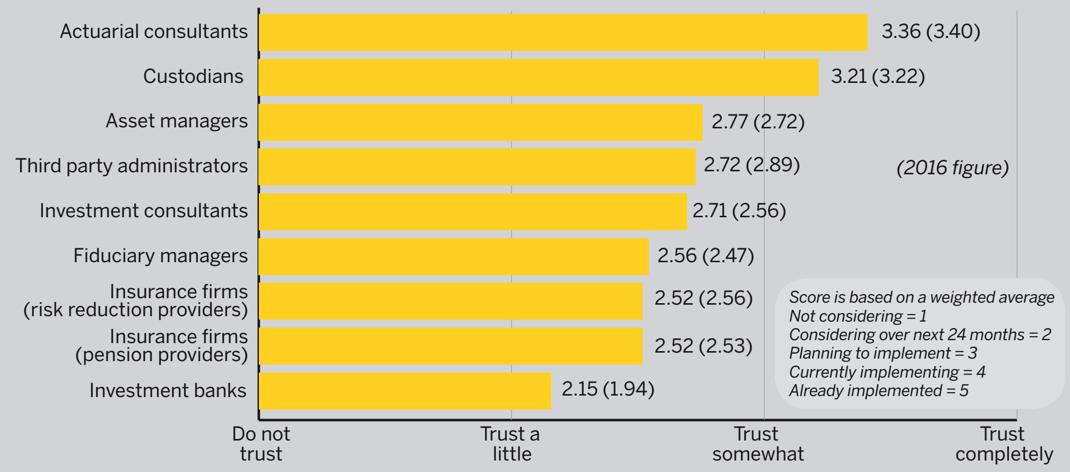
with a score of 163 (2016: 118); inflation risk, with a score of 130 (2016: 80); and regulatory risk, with a score of 48 (2016: 40).

Interestingly, the biggest risks faced by schemes was also dependent on size – with the biggest, £1bn-plus, and the smallest, sub-£100m, scheme respondents saying investment risk was the biggest issue, followed by interest rate risk and longevity risk.

Medium sized scheme respondents – those with assets of between £100m and £1bn – ranked interest rate risk top.

We also asked about Brexit and how this ranked

To what extent do you trust the following organisations?



Breakdown of trust levels by organisation type (2016 figure)

	Trust completely	Trust somewhat	Trust a little	Do not trust at all	No Opinion
Actuarial consultants	44% (44%)	46% (47%)	8% (4%)	1% (1%)	1% (4%)
Asset managers	10% (8%)	59% (56%)	25% (29%)	3% (3%)	2% (4%)
Custodians	31% (31%)	46% (41%)	11% (13%)	1% (0%)	11% (15%)
Fiduciary managers	8% (8%)	35% (29%)	20% (21%)	10% (12%)	26% (30%)
Insurance firms (pension providers)	7% (11%)	44% (31%)	27% (33%)	11% (8%)	12% (17%)
Insurance firms (risk reduction providers)	7% (7%)	41% (37%)	24% (32%)	11% (6%)	18% (17%)
Investment banks	2% (3%)	29% (14%)	35% (46%)	20% (26%)	14% (10%)
Investment consultants	10% (10%)	55% (42%)	27% (33%)	5% (9%)	3% (6%)
Third party administrators	10% (16%)	50% (54%)	29% (21%)	3% (3%)	8% (7%)

The Financial Conduct Authority published the results of its interim asset management market study last year. How much do you agree with the following statements?

as a risk. Perhaps surprisingly, this topic ranked very low down the risk list, with a weighted score of just 57.

This lack of concern over Brexit was reinforced with a question asking respondents if they have changed or are planning to change their scheme investment strategy following last year's EU referendum.

An emphatic 53% of respondents said no, a further 36% said it was too early to say and only 10% said they had already made changes or were planning to make changes to strategy.

The respondents who had made changes said these included increasing hedging or bond holdings and reducing equity weightings.

TRUST

The second section of our research looked at trust. According to our research, an overwhelming 86% (2016: 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 13% (2016: 8%) ranking it as "important" and 1% (2016: 1%) ranking it as "a little important".

Yet, trust in providers and consultants is remaining reasonably steady, with just 5% of respondents saying their level of trust had decreased over the past 12 months and 3% saying it had increased. Most, some 92%, said their levels of trust had stayed the same.

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 52% (2016: 55%) of respondents listing this among their most important criteria. This was followed by "quality of advice or products", listed by 48% (2016: 51%) of respondents; "admitting mistakes if they are made", listed by 44% (2016: 43%); "strong personal relationships with key individuals", ranked by 41% (2016: 47%); and "transparent and understandable fees and costs", put forward by 39% (2016: 45%).

Other options, such as customer service, communications were ranked less highly by respondents. Having a strong organisational brand was not ranked at all by respondents.

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

Trusted advisers?

Respondents were also asked 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 and four, with four being the most trusted and one being the least trusted.

Once again this year, actuarial consultants topped this list with a score of 3.36 (2016: 3.40), followed by custodians with a score of 3.21 (2016: 3.22). Asset managers moved into third place, with a score of

2.77 (2016: 2.72) and third-party administrators came next with a score, slightly down on last year, of 2.72 (2016: 2.89).

Perhaps surprisingly, the biggest improvement in scores, when compared to the 2016 survey, was for investment consultants, which saw their trust score increase from 2.56 in 2016 to 2.71 in 2017.

REFORM

This year, we also asked respondents some questions about key areas of pension scheme reform – looking at areas including the Financial Conduct Authority's (FCAs) asset management market study and the green paper on DB security and sustainability.

Further to the FCAs asset management study, we presented respondents with a series of statements – asking them to what extent they agreed with them on a scale of -5 (disagree completely) to plus 5 (agree completely).

The statements that had the highest weighted scores – those which respondents agreed most with – included: "At 36%, the average profit margin of asset management firms may be too high", which had a weighted score of 2.96; "There is no clear relationship between price and performance for actively managed funds", with a score of 2.72; and "There is a lack of transparency when it comes to transaction costs", which had a score of 2.63.

We also asked about the Department for Work and Pensions' green paper, asking respondents what they thought the most significant reforms would be in order of importance.

The two key reforms with the highest weighted importance scores were "making special arrangements for schemes and sponsors in certain circumstances" (506) and "giving members further protection, delivered either by a stronger regulator, and/or by trustees with enhanced powers" (500).

Other issues flagged as important included "taking action to encourage, incentivise, or in some circumstances mandate the consolidation of smaller schemes into vehicles with greater scale" (433); and improving the investment choices available to DB schemes (426).

We also asked respondents if they thought there was anything the government isn't considering that it should.

Answers to this question included alternative valuation measures; issues around section 75 debts and modifying indexation requirements. PP

The Department for Work and Pensions has published its green paper looking at a number of DB reform options. What do you believe the most important reforms would be, in order of importance? (Weighted importance score)

506
Managing special arrangements for schemes and sponsors in certain circumstances

500
Giving members further protection, delivered either by a stronger regulator and/or trustees with enhanced powers

433
Taking action to encourage, incentivise, or mandate the consolidation of smaller schemes into vehicles with greater scale and better governance

426
Improving the investment choices available to DB schemes through government/ regulatory action, scheme consolidation or asset pooling

401
Changing valuation cycles

300
Doing more to keep scheme members informed about the funding position of their schemes

Research methodolgy

This report details the findings from *Professional Pensions* research conducted in March 2017 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 152 trustees and pension professionals in the UK. All interviews were carried out online using Computer-assisted Web Interviewing (CAWI).

Overall, some 52% of respondents described themselves as trustee, 27% were pension scheme managers and 6% were finance directors. The remainder of respondents' occupations (15%) included consultants and advisers as well as those with other scheme roles.

Taking advantage of risk events

Jonathan Stapleton talks to PIC head of strategic development David Collinson about how schemes can take advantage of risk events in the light of political and economic uncertainty

The EU Referendum on 23 June last year was followed by the election of Donald Trump as US president in November and a UK General Election in June 2017.

Yet, despite a seeming increase in volatility, schemes are still conducting risk reduction transactions – with Pilkington Superannuation Scheme's £230m buy-in, conducted in the immediate aftermath of last year's Brexit vote, being a prime example of how deals can be done in volatile times.

Pension Insurance Corporation head of strategic development David Collinson says preparation is key to being able to transact in volatile markets – noting that schemes need to have a plan for reducing risk, know what they consider is an acceptable price for moving this risk and are able to move relatively quickly when that pricing target is hit.

He also says schemes need to be resolute and confident in their pricing target.

Collinson explains: "If there is a market movement and you hit your pricing target for removing risk, you could start worrying whether or not this is the best time to do it as it could be better next week or the week after.

"It's perfectly right to ask if the world has changed and to question previous research and analysis into the price at which you de-risk; considering if there has been a fundamental shift and whether the price previously set is no longer appropriate, but to worry about whether you get a better deal next week is counterproductive, because you end up delaying and missing the opportunity."

> **"It's about having a more long-term view on what works from a pricing perspective for de-risking and then acting on that and not doubting yourself"**

He adds: "This isn't a question of trying to second guess short-term market movements, because few will ever do that successfully. It's about having a more long-term view on what works from a pricing perspective for de-risking and then acting on that and not doubting yourself.

"It's all in the plan. Do you take that opportunity to lock down and make that contribution schedule more certain? And I think companies in the de-risking mindset will do so."

Deal in brief: Pilkington Superannuation Scheme

- The Pilkington Superannuation Scheme concluded a £230m buy-in with Pension Insurance Corporation in the middle of 2016 – securing favourable pricing in the wake of the EU referendum.
- The scheme benefitted from the rise in the value of gilts after the Brexit vote and exchanged them for a buy-in policy, insuring a proportion of its pensioner liabilities.
- A full case study of this deal can be read on page 32.

Moving quickly

But how do schemes make these sort of deals happen in a matter of days when short-term opportunities present themselves? How do they get all the relevant parties together to make sure a deal can actually happen?

Collinson says that trying to hit windows that last for one or two days isn't something schemes can really plan for – noting that everything has to be in place to move that quickly.

But he says employers and schemes can take steps to make sure that, should a window appear and it does last for a reasonable period of time, they will be able to take advantage of it.

Collinson explains: "You are not going to be able to go from not considering a transaction at all to spotting the market conditions are right to transacting within two to three days.

"What you can do, however, is make sure you know what it takes to transact and, working with your advisers, calculate how long will it realistically take to reach agreement on a transaction."

From this point, Collinson says, schemes can then assess whether this time to transact is too long and explore whether it is worth investing some time and expense now in order to shorten that time period.

Existing relationships

The schemes that are able to move quickest – and are best placed to take advantage of very small one or two day transaction windows – are often those that have conducted previous transactions and already have the contractual arrangements and relationships in place.

And Collinson says that, for big schemes, doing an initial tranche to test the market and having a dialogue with insurers to flesh out both the trustee's and company's overall view on contractual terms, as well as any scheme-specific features that need to be dealt with in a contract, can be advantageous.

Collinson explains: "You might have specific features and trustee rules that are a bit tricky, that take more than just a day's negotiation to turn into contractual wording. There are a lot of plus points about doing an initial transaction, though it may be smaller, and it will give you much greater optionality should you want to do more insurance later on."

Other preparations

However, what happens if you are in a position where you have done very little to prepare for an insurance transaction? What are the incremental steps you can take to reduce any transaction timeframe?

Collinson says that, while it is not essential, sorting data out is important – not just for insurance transactions but the ongoing management of the scheme as well.

He notes: "You are making significant financial decisions about the ongoing management of the scheme based on the data you have and you don't want your funding decisions to be flawed because they weren't based on solid, credible data.

"Time spent on improving data is not wasted from any aspect, irrespective of whether you're de-risking or not."

Collinson also believes time spent understanding what a scheme's de-risking options are and understanding views on risk and return is also an important step.

He says: " Having this understanding will enable you to decide what you think value for money is and whether you believe, for example, insurance contracts are value for money compared to the alternatives.

"Because you need to have that mindset and to have decided what represents value for money and when you think insurance is cheap or when you think it is expensive compared to other options."

At the same time as this, Collinson says trustee boards should also be engaging with the sponsoring employer, getting them to buy into any decisions and understanding that value proposition.

Collinson explains: "Our experience is that transactions are generally only successful, particularly the bulk annuity transactions that we do, if both the sponsor and the trustees are actively involved, engaged and supportive of the transaction."

He adds: "With most of the large transactions we've worked on, it has been a joint project with the sponsor and the trustees – and both have been supportive of the transaction. Of course, they will have their differences and there will be things that will need to get negotiated out, but the overall concept is that they should both be in alignment saying this is something we want to do."

Collinson says this process is all part of the sponsor and trustee agreeing a longer term strategy for the pension scheme and having a joint and shared vision for how the pension scheme will evolve in the future.

"There needs to be a common view there," he says. "The trustees have direct responsibility for the scheme and obviously the sponsor, as the financial backer of the scheme, has the major interest in agreeing that future."

Collinson also advises trustees to get help with the process – noting there has been a significant evolution in the scope and depth of the consulting resources available to trustees in this area over the past 10 years.

He says: "There's very good consulting support available from very experienced consultants who have been through this a lot.

"So I would advise any trustee group really to tap into that and bring in some consultants to help them understand how best to move from where they are to where they want to be."

Future risk events

Collinson believes there is more potential for risk events to happen going forward as the UK goes through what is likely to be a tricky European Union exit and as the world, generally, looks less certain than previously.

He says: "There is certainly more potential now, looking forward, especially looking at UK based pension funds with sterling-based liabilities and exposure both to sterling assets and foreign currency movements.

"You can certainly see that the world looks like there is more scope for corrections or market movements. Interestingly, while the triggering of Article 50 was largely priced in to markets, I think there is potential for market corrections when unexpected news comes out or when news is more negative or positive than was being priced in. And, inevitably, with such a large negotiation, those sort of events are going to occur." PP

"With most of the large transactions we've worked on, it has been a joint project with the sponsor and the trustees – and both have been supportive of the transaction" David Collinson

How the Aon Retirement Plan conducted its £900m buy-in

Jonathan Stapleton speaks to Aon Hewitt partner Paul Belok and Pension Insurance Corporation senior actuary Matt Barnes about the deal

Jonathan Stapleton: Paul, could you tell me about the background to this deal?

Paul Belok: Aon has had quite a significant focus on its pension schemes over the past few years – it had seen contribution requirements being quite volatile and put in place a structure and plans to manage down the risk, particularly in terms of the cash flow implications for the corporate.

One of the things it did was to put five of the UK pension plans it operated into a single sectionalised plan, which is the Aon Retirement Plan. There's also another plan, which is the Aon Minet Scheme, which is also going down the same sort of route and has also completed buy-in transactions previously.

Over time, the Aon Retirement Plan has taken quite a lot of risk out in terms of the investment side to the extent that for three of the five sections in particular, longevity risk was probably one of the more significant risks that were still retained within the scheme.

So the scheme's focus was then on what we do about that – and starting to explore opportunities around that. That encompassed looking at the raft of opportunities that were out there to deal with that risk, concluding with the decision to look at doing this buy-in, which made sense commercially and economically from the scheme's point of view, and also from the corporate's point of view and ultimately the members' point of view.

In terms of the funding position, the impact was actually slightly positive, based on the pricing that was available at the time. But if the price had not been at the right sort of level, then the transaction would not necessarily have happened.

Jonathan Stapleton: Matt, this was the first sizeable pension insurance transaction under the Solvency II regime. Did this have a material impact on the deal?

Matt Barnes: First of all it was crucial that PIC had got its house in order in terms of applying Solvency II to its business as a whole – getting all the relevant regulatory approvals towards the end of 2015, which allowed us to continue to engage fluidly with the market through into 2016 and complete this, which was the largest deal in the first half of that year.

> **"First of all it was crucial that PIC had got its house in order in terms of applying Solvency II to its business as a whole"**
> **Matt Barnes**

In terms of the direct impacts, Solvency II requires much closer matching of assets to liability cashflows and so a little bit more work had to be done, in parallel with the transaction, to prepare and execute the asset strategy at a very granular level, perhaps more so than under Solvency I.

In addition, Solvency II effectively requires an insurer to hold capital for longevity risk twice – and has introduced this concept of a risk margin that doubles up on longevity capital. That meant we had to think very carefully about how we would execute the transaction and made sure we lined up reinsurance to come into play relatively soon after the transaction.

Jonathan Stapleton: To what extent did Solvency II have an effect on pricing?

Matt Barnes: From our perspective, Solvency II has probably allowed us to be slightly keener, slightly more competitive on pensioner transactions because of how the Solvency II

The buy-in in brief

- Aon Retirement Plan's £900m buy-in – conducted with Pension Insurance Corporation in the first quarter of 2016 – was the first sizeable pension insurance transaction under the Solvency II regime.
- The transaction, which was primarily funded with gilts, covered the majority of pensioner liabilities across two sections of the five-section segregated plan.
- The deal enabled the £4bn Aon Retirement Plan to take "a significant step" in its long term de-risking plan.

Aon is headquartered in the City of London's iconic Leadenhall Building, popularly known as the Cheesegrater

regulation allows us to take into account the yields of corporate bonds in a slightly different way to Solvency I. But for other transactions, full buyouts that might involve deferred members, and this wasn't one of that type, the pricing has gone up, I'd say.

Paul Belok: I think the timing of this transaction was interesting in the context of Solvency II. In the run-up to the introduction of this regulation, one or two commentators suggested that Solvency II was going to see pricing increase by as much as 10% or something.

We were never in that camp, but nevertheless, we were conscious that there was some degree of uncertainty around whether there was going to be an overnight flip in terms of the pricing for this particular transaction, or how would it be affected by Solvency II. So to an extent, we managed the process so we had options to go either before Solvency II came in or shortly afterwards.

So certainly, as Matt said, I think for pensioner pricing there's been a pretty limited impact. However I think it varies a bit by insurer how quickly they got to grips with things; how quickly they got the infrastructure in place; and how quick off the mark they were in terms of

"In the run-up to the introduction of Solvency II, one or two commentators suggested that it was going to see pricing increase by as much as 10%. We were never in that camp"

Paul Belok

"The combination of the trustees' decision-making and the provision of the quotations to support that meant that the trustees could lock in while pricing was very attractive"

Matt Barnes

identifying suitable assets that could work under Solvency II effectively and then accessing those assets.

At the most competitive end of the market, the impact of Solvency II was not really noticeable in our experience in relation to pensioner pricing. Certainly, the fact that we ended up transacting post-Solvency II indicates that was certainly not an issue for this particular transaction.

However, as Matt says, it's been more difficult where deferred pensioner pricing has been in play given the longer duration and the issues around not being able to access longevity reinsurance or long-dated assets to cover these.

Having said that, more recently, we're seeing some attractive pricing for deferred pensioners as well, which suggests that insurers are now finding solutions to these issues.

Matt Barnes: Paul, unrelated to Solvency II, I remember that the first quarter of 2016 was a fairly good time for pricing because credit spreads were wide. And I recall we did a lot of quoting for you in January/February 2016 in the run-up to the transaction. I feel that the combination of the trustees' decision-making and the provision of the quotations to support that meant that the trustees could lock in while pricing was very attractive at that point and maybe would have been less so a few months later.

Paul Belok: That's correct and the relative competitiveness of the market, and how this is affected by issues such as credit spreads, is something that we also track for clients. So we were looking to try and take an opportunity when the conditions were positive in that sense and that came through well for this deal.

We were also able to get some confidence around the pricing and how that was likely to move in the run-up to the deal, compared to the key metrics that the trustees were looking at in terms of comparison numbers relative to the premium. We were able to lock into that with PIC in the run-up to actually finalising the transaction, which was very helpful.

Jonathan Stapleton: Paul, are there lessons you feel other schemes can learn from this deal? What was the process you followed with this deal?

Paul Belok: I think deals of this sort of size tend to be a little bit unique, I would say. Each one is different, each one has its own complexities and so on. So it's not necessarily that easy to draw a particular read-across. But clearly from our point of view, we're eating our own cooking, if you like. We're telling our clients that this is something that they should be looking at in the right circumstances, and the fact that we have done this for our own schemes is a great endorsement.

The process we followed is one that we operate as part of our Compass offering for clients. So, as you would expect, a lot of planning goes into it and the more you can get sorted out up front, the better, in terms of understanding what your key criteria are; what your metrics are for gauging whether a price looks a good one or not; and getting the decision-making processes up and running.

This case was quite complex, looking at a raft of different ways in which we could slice and dice the benefits as part of a buy-in as well as other alternatives. Obviously we did consider the longevity swap marketas well; that was part of the thought process that went into this. So there are potentially a few more factors coming into play than for some other schemes. But clearly, schemes of a similar size will probably have similar issues to take on board and to work through.

Have we adapted our standard approach for other clients on the back of this? Not particularly. We simply used the approach we currently offer and followed that; it's something that we've obviously honed over the years and we feel it works well and works efficiently and gets clients to the right outcome. I think from both the trustees' point of view and the corporate's point of view here, the outcome was a very positive one.

Jonathan Stapleton: You were comparing buy-ins with lots of other options as well. Was this simply about getting the best value option or was it about getting one that took the most risk off the table?

Paul Belok: I think there's a number of factors which come into play: looking at relative value, but also thinking about longer-term game plans and what fits well with where the scheme's ultimate objectives lie. So a number of factors were weighed in the balance before concluding that if the price was at the right level, then the buy-in was the route to go down. And it transpired we could get that price.

Jonathan Stapleton: Apart from Solvency II, were there any unusual elements of the process?

Matt Barnes: The scheme has, for one of its sections, a fairly unusual type of inflation linkage and, as part of the process, we had time to look at that closely and discuss whether an approximation would be suitable or not.

In the end we concluded, after doing some complex modelling at our end, that we could exactly match the scheme pension increases – allowing the trustees to get a perfect match in their transaction. So it was helpful that the process allowed us the time to invest in getting that right for them.

Paul Belok: That's a very helpful point actually, Matt, because I think we went into the process wondering whether the market could handle that particular increase, which applied to the larger of the two sections we were looking at; and if they could, could they price it at a sensible level?

So I think we were prepared to look at insuring something that wasn't an exact replica, but PIC put a lot of work into figuring out a way to match those increases. From our point of view, and from the trustees' point of view, the ability to insure exactly what the benefits are under the scheme is obviously strongly preferable to insuring something that's close but not quite the same thing.

Jonathan Stapleton: Is there a message for other trustees there? That if they have slightly non-standard benefits structures they think may not necessarily fit into a buy-in or a risk reduction exercise, it is worth speaking to your consultants and insurers to check if their assumptions are correct?

Paul Belok: Yes, absolutely. Obviously the size of this transaction probably helped with the level of flexibility and the amount of effort the market was prepared to put into looking at things.

But you do need to take a view on this and, if the cost of getting exact matches is excessive, then you need to consider whether that cost is worth paying or whether getting something that's a close but not absolute match is the better route.

The market is pretty clued up these days and can cope with most things that get thrown at it. But you do need to, on the odd occasion where something is particularly complicated or poor value, engage with insurers and also have a means of assessing whether to insure an exact match or something slightly different.

"We simply used the approach we currently offer and followed that; it's something that we've obviously honed over the years and we feel it works well and works efficiently and gets clients to the right outcome"
Paul Belok

How trustees are

PP asks four independent trustees about the progress their schemes are making on de-risking, the bars to risk reduction and future trends

Panel

Samiea Ashraf, associate director, 2020 Trustees
Ashraf is an associate director in the Manchester office of 2020 Trustees. She is a qualified pensions actuary with significant pensions, actuarial and trusteeship experience. She currently acts as trustee to several pension schemes with specialism in complex funding situations.

Donny Hay, client director, PTL
Hay is a client director of PTL and has more than 25 years' experience in the pensions and investments industry, both as an asset manager and as an independent trustee.

Q How close are the pension schemes you work with to a buy-in or buyout at the current time? What do you see as the bars to such insurance-based solutions?

Ashraf: We have several schemes that are closely monitoring buyout terms and we expect a significant proportion will transact by the end of the year assuming markets do not move materially against us. Most of these schemes have been planning for buyout for a few years.

Given current insurance pricing, buyout does remain a much longer term objective for the bulk of our schemes. The cost of buyout can be significant for sponsors and given the current economic uncertainty most are conserving cash to use to fund future growth initiatives.

The main barrier to insurance is the pricing terms, especially for smaller schemes (i.e. those with assets, say, under £25m) where the ability to create a competitive insurance tender is greatly reduced.

> **"The main barrier to insurance is the pricing terms, especially for smaller schemes where the ability to create a competitive insurance tender is greatly reduced"**
> **Samiea Ashraf**

An additional barrier is the premium charged for insuring deferred members who have some time until retirement. Deferred premiums appear to have been hit particularly hard by Solvency II and this has moved some of our monitored schemes much further away from transacting.

Insurers also tell us that recent tightening of credit spreads have led to price increases which, compounded with Solvency II, have presented material difficulty with transactions that were previously very close to enacting.

Hay: Some schemes are close to buy-in, few to buyout. Research suggests that, on average, schemes are about 85% funded on a technical provisions basis but on a buyout basis, it will be far lower than that, 60-70%, so there is quite a big gap.

Barriers to buyout include: adviser costs, which can be £50,000 or more; the cost to the sponsor; legal uncertainty about benefits, especially in areas such as guaranteed minimum pension (GMP) equalisation and data quality; and the number of deferred members, which are often very expensive to insure given greater uncertainty around benefits. Also, the exercise can be very time consuming for a trustee board.

Getting realistic quotes is hard unless you are very serious – it is lot of work for an insurance company to run all your data through their systems, to look at the data to see how clean it is, and to do all the necessary tests in order to give as good a price as they can. If they can't get clean data, or they are not able to do enough analysis as to where the risks lie within the liabilities, then they won't price it as competitively.

Kennett: Each scheme has its own specific characteristics. However, the majority of schemes are funded considerably below full buyout. Some schemes have bought-in slices of their liabilities – most frequently those of older or higher liability pensioners. There are a number of difficulties to overcome however. These aren't insurmountable, but include a number of things.

First, insurers are charging a significant premium relative to the funding basis our clients are typically using to determine their technical provisions and therefore the additional funding required is considerable.

In addition some advisers are charging high costs for these exercises; there are often benefit and data uncertainties, including GMP equalisation for example; and there are difficulties in minimising variations between how the insurer pricing moves and how the scheme assets move.

A change in mindset of all parties involved is also required as the quarterly meeting schedule simply isn't effective.

Finally, there are some concerns over insurer appetite – there has always been a lack of competition for insurance transactions for smaller schemes, which has reduced further with some smaller schemes struggling to find anyone willing to quote.

Phelan: There are probably two camps. Firstly,

reducing risk

those schemes that have got their investment strategy lined up with liabilities and have had some decent returns. These schemes are probably close to transacting either on a buy-in or, for some of them, a full buyout.

The other camp are schemes who, with where yields are, are probably 10 years away from being able to fully buyout but, along that journey, are very much looking to transact on a buy-in if possible.

What are the bars to this? I think the obvious one is funding, and that really is the main driver of whether people are looking at insurance-based solutions or not.

Q How are your schemes preparing for any future transaction? What are the key areas, if any, you are working on?

Ashraf: As a minimum we are getting our schemes buyout ready by undertaking data exercises aimed at ensuring the quality of the data and thereby potentially improve pricing terms.

Liability management exercises remain a standing agenda item across all our schemes and are in various stages of completion. We accept there is a potential selection risk created in running liability management exercises as a pre-cursor to buyout however at present this is a risk we are prepared to accept as part of the overall de-risking framework.

Hay: Where relevant, schemes are monitoring pricing, cleaning up data and having a plan which ties a future buyout into the investment strategy.

One area that can be a stumbling block however is the pension accounting hit in the year you carry out a buy-in or buyout, which can be a barrier for the employer. Accounting rules allow you to value liabilities at corporate bond levels, but a buyout or buy-in is very much a gilts-based measure so, in the year that you complete any insurance transaction, you are going to have an increase in the value of the liabilities you are putting into buy-in or buyout and that needs to be recognised.

Kennett: Key areas schemes are working on include the consideration of investment strategy targeting buyout over the medium to long-term, data cleansing, benefit audit and rectification, and liability management.

Contractual negotiations are another area of focus – with some people looking at the cessation of accrual

Panel

Adrian Kennett, director, Dalriada Trustees
Kennett is a director of Dalriada Trustees and head of its ongoing trusteeship practice. He acts as both trustee chair and member of the board of trustees on appointments ranging from schemes with liabilities of £10m to £1bn and has over 24 years' experience in the pensions industry.

Wayne Phelan, managing director, PS Independent Trustees
Phelan began working as a professional trustee in 1990 and currently works with a range of clients, from small independent companies to multinationals, and has worked on many high profile trustee appointments. He also leads PSIT's research into scheme de-risking and delegated investment management.

"As everyone wakes up to the fact that yields are going to be lower for longer there is an equal realisation that insurer pricing is unlikely to dramatically improve in the short- to medium-term"
Adrian Kennett

or severing of ongoing salary linkage for example.
Phelan: There are two elements to this. The first is on the practical, operational side and making sure your data is in good order; and making sure you know exactly what benefits you are going to secure, which tends to lead to having a good benefits specification available to then take to the insurers, something which shows that you are not only serious about a transaction but also makes sure you are valuing the right liabilities.

The second element, and probably the more practical one for most people, is looking at the investment strategies and the contribution patterns to get there.

Most of our schemes have refined what they are doing to make the journey more predictable and, hopefully, more certain. These refinements include the increased use of liability-driven investment (LDI), a bit more diversification in growth assets and a lot more monitoring of how well the funding position does to lock in any gains.

Q To what extent do you believe there is a significant pent-up demand among schemes waiting for costs of insurance-based risk reduction exercises to fall?

Ashraf: There is strong demand as defined benefit (DB) schemes become more of a legacy issue. Ultimately it comes down to price and the gap between a scheme's current funding position and buyout. More fundamentally, it is difficult to see insurance-based solutions falling in price in the current climate of increased solvency reserving demands, retained high-level demand for bonds and upward creeping inflation. Outside of innovation which we currently have no insight into, we struggle to see how the costs will shift by the quantum needed to satisfy the waiting demand.

Hay: There is a bit of pent-up demand but most schemes are waiting for their funding gap to close, using this waiting period to get their house in order and clean up their data.

Indeed, most pension funds are now doing work with their administrators to clean up their data and that is necessary to do exercises like buy-ins and buyouts.

Kennett: A look at the regulator's Purple Book indicates a massive shift away from ongoing DB accrual over the last decade which hasn't been mirrored by an increase in the number of schemes winding-up. Some 66% of members in 2006 were in open schemes. By 2016 that figure was 19%. Less than 1% of members are in schemes which are winding-up. Given the increasingly legacy nature of these schemes and the volatility in the funding which must be disclosed, there is a desire to remove the scheme from the company balance sheet.

"Most pension funds are now doing work with their administrators to clean up their data and that is necessary to do exercises like buy-ins and buyouts"
Donny Hay

Solvency is expensive in a low yield market place but on the other hand the cost of borrowing is relatively low and therefore some sponsors are willing to borrow the shortfall to remove the risk while others would rather let their investments do the hard work.

As everyone wakes up to the fact that yields are going to be lower for longer there is an equal realisation that insurer pricing is unlikely to dramatically improve in the short- to medium-term.

Some are looking to other risk reduction strategies whilst others are making hard decisions about how long they have to or can wait. Those that can't afford to borrow to reach buyout/in levels in an acceptable timescale are looking for alternatives such as population slicing or Pension Protection Fund (PPF) plus compromises. Therefore, there remains a steady flow of insurance-based risk transactions with some funded by credit, some for slices of the population and some for reduced benefits.

Phelan: There is probably a massive amount of demand sitting in there. I think that any finance director, owner or manager of a business has probably taken the view they never want their door darkened again by these liabilities – if they can transact at a nil cost or low cost to get them off their books forever, I think we will see a lot of demand for that.

But this demand is not necessarily matched by either supply of insurance or advisory capability - there are some specialists in this area but getting this right occupies quite a lot of bandwidth.

Q To what extent are your schemes currently looking at or conducting liability reduction exercises such as enhanced transfer values (ETVs), flexible retirement options (FROs), pension increase exchanges (PIEs) or trivial commutations. What are the challenges you face when looking at these?

Ashraf: As mentioned, liability management remains a standing discussion item at our trustee meetings. We believe such exercises should be run by companies and trustees in a collaborative manner to provide members with additional options in an easy to understand manner. Independent financial advice is a must for such decisions.

The challenges mainly centre on how independent financial advisers are being hindered by rigid Financial Conduct Authority (FCA) guidance in assessing transfers. Using a formulaic transfer value analysis (TVAS) approach is not the appropriate way to analyse most retirement decisions.

Almost all our schemes have undertaken trivial commutation exercises.

Hay: Lot of schemes are looking at most of these

– FROs are popular; PIEs are being considered but have a limited impact; but there is no demand for ETVs as, with the introduction of the pension freedoms, straightforward transfer values have become a popular option at or near retirement.

The challenges can be the cost of undertaking liability reduction exercises; providing individual financial advice; and the time involved for both trustees and sponsors.

Kennett: Defined contribution (DC) pensions flexibility raised sponsor hopes of a rush to transfer out of DB schemes and, while interest has been high, the increase in actual transfers has not been as material as some predicted. On some of our schemes there has been interest in transfer values particularly among members with sizeable liabilities who might have lifetime allowance issues or are planning for inheritance.

Interest from sponsors in liability reduction remains high however, but when they realise the cash influx needed to make an exercise successful their eagerness often dissipates.

And, as with all liability management exercises, the challenge we face as trustees is ensuring that members are presented with complete and accurate facts, that the appropriate advice is available and that the relevant guidance has been followed. DB pension schemes can be complex beasts – the issues which members are being presented with are correspondingly complex.

Those issues need to be explained in a fair and transparent manner.

Phelan: ETVs were, at one point, quite attractive but I think the market has moved forward as transfer values are at an all-time high for members and most schemes aren't having to enhance because they look very attractive anyway.

As a result, a lot of schemes are now looking at whether they remind people that a transfer value is an option but not enhance it, and we are seeing quite a lot of interest in that.

PIEs are the area that we really support. In my mind, pensions always got it slightly wrong in that people tend to have the biggest pension when they are the least likely to be able to spend it, ie in their 80s or 90s when most people want to enjoy their last flush of youth in their 60s or 70s. As such, exchanging increases for a higher initial pension is something that is really attractive, easy to implement and easily understood for members, so we are seeing quite a lot of traction around that.

Some of the smaller elements in terms of trivial benefits and those sort of things are more of a tidying up exercise rather than necessarily having a big impact on helping schemes secure the benefits in full, but getting rid of smaller records is a nice thing to do as it leaves you with a smaller number of records to focus on.

Q What do you believe will be the key risk reduction trends among the schemes you work with over the coming 18-24 months?

Ashraf: We expect mainly at-retirement options to increase in demand over the next two years.

We also expect more sophisticated investment products to become more widely available to all scheme sizes to allow for better risk protection (i.e. derivate overlays or absolute returns with LDI).

Hay: One of the key trends will be for schemes to increasingly automatically quote transfer values at retirement or when people ask about pensionable salary. FROs, PIEs and trivial commutation will also continue to be popular.

Providing transfer value quotes is something a lot of schemes have been considering. Take-up of these quotes can be in the high single digits in some cases – and it is often popular among higher-paid employees with other arrangements elsewhere. I think this trend will continue.

I also expect schemes will increase the amount of assets they hold in matching assets and LDI strategies.

Finally, I think the growth in fiduciary management, which tends to accelerate liability management, will continue.

An increasing number of trustees and sponsors are going to want to outsource investment complexity and that is what fiduciary management is about. And that is going to be attractive to many schemes as consolidating the arrangements in this way can have many benefits in terms of costs, greater access to sophistication, and operational capability.

It is not a panacea, but I think DB schemes, particularly those that are closed to new members and future accrual, are seen as legacy debt problems for sponsors and they want them dealt with efficiently and cost effectively. Options like fiduciary management are becoming more popular because of that.

Kennett: There are a number of key areas – including a focus on the British Steel Pension Scheme, with a number of companies watching the outcome of this closely.

In addition to this, there is likely to be an increased implementation of asset de-risking, using strategies such as LDI, as well as a continued diversification of growth assets, with some schemes moving into illiquid asset classes.

Many schemes may also implement trigger structures; implement PIEs, FROs or trivial commutations; or consider a move towards fiduciary management.

Finally, I think there will be continuing work on data and benefit rectification, particularly with regards to GMP reconciliations.

Phelan: I think there are going to be two key things. One is liability measurement and whether people look more at LDI; even though you could argue that it is a challenging time to do that, it still has a function and is capital efficient.

The real challenge is going to come from the growth assets and making sure that they deliver – we are in a period of complete uncertainty, whether that is Brexit, whether that is the global economy, all of those sorts of things.

I think we are going to see a lot more challenge around how growth assets achieve their returns and, more importantly, whether things like diversified growth funds really are delivering what is expected of them.

"The real challenge is going to come from the growth assets and making sure that they deliver – we are in a period of complete uncertainty, whether that is Brexit, whether that is the global economy, all of those sorts of things"
Wayne Phelan

Building a relationship

PIC has invested around £700m into social and affordable housing. **Jonathan Stapleton** speaks to the insurer's head of debt origination, Allen Twyning, to find out more

Deal in brief: Aldwyck Housing Group

- In April 2017, Pension Insurance Corporation announced it had invested £40m in secured debt issued by Aldwyck Housing Group, a housing association providing more than 11,000 homes and management services for around 25,000 people.
- The fixed-rate debt matures in 2033 and matches PIC's pension liability cash flows.
- The debt is secured on Aldwyck's social housing properties and is being used to refinance existing debt and build over 800 new homes.
- The transaction was arranged by NatWest Markets as sole agent.
- PIC said the investment not only matched its long-dated pension liabilities, but was also beneficial for the economy and should help to provide more accommodation in areas of high demand.

To date, Pension Insurance Corporation (PIC) has invested around £2.5bn in directly sourced debt investments, including over £700m in social and affordable housing across the UK.

PIC head of debt origination Allen Twyning says the insurer lends to registered providers of social housing, with these loans secured on a portfolio of homes.

But, he explains, PIC also gets involved with other transactions too – including a number of social housing private finance initiative (PFI) transactions, deals which typically involve a local authority putting a project finance structure around a portfolio of potentially quite dilapidated stock in order to bring it up to a much higher standard.

It has also been involved with some slightly less straightforward transactions that have been more unique in nature. One such deal was the £70m secured debt deal to fund retirement housing in the Church's Housing Assistance for the Retired Ministry (CHARM) scheme, provided by the Church of England Pensions Board.

This investment, in which PIC is the sole investor, is linked to CPI and secured against a portfolio of residential assets.

PIC also invested in £93m of secured debt issued by the Welsh Housing Partnership – a partnership supported by the Welsh government and set up to deliver new affordable housing for four housing associations.

This deal was particularly innovative as £10m of the loan was deferred for four years.

"The core of what we look to do is ask are these assets good quality, in demand and can they sustain long-term debt?"
Allen Twyning

Rationale

PIC says the key reason it does these sort of deals is to match its cash flows, something that has become particularly important under Solvency II.

Twyning explains: "Year by year we have liabilities to match and we have to go and find high quality credit assets to match those liabilities.

"Previously, we were doing these things because we felt they were a good diversifier and we saw value but now, with Solvency II, it has become exceptionally useful for us to work with borrowers and agree a cash flow profile that works for them and works for us."

Twyning cites the example of US dollar denominated corporate credit, which is typically issued in durations of up to 30 years.

"Once you get beyond 30 years you really are struggling to find suitable assets in the US dollar market," he says. "It's a little bit easier potentially in the sterling market but there isn't a huge amount of supply.

"So we've found these kind of directly sourced transactions particularly useful when going out beyond 30 to 40 years, where we can't find public bonds that are there to match our liabilities."

Origination

But while these deals are proving invaluable to help it match liabilities, finding such opportunities can prove challenging for an organisation that doesn't have access to the same large network as a bank.

Twyning says there are two main routes it uses to originate deals. First, he says, is the traditional bank-led private placement process, where a bank will take a borrower round to a handful of investors who are known to be active in the sector and then facilitate a bidding process.

The other route is to use specialist intermediaries who will advise and arrange the debt – a route Twyning believes can make a lot of sense in the fragmented housing association market.

Once a deal has been sourced, however, PIC says it then needs to do an in-depth credit assessment to ensure it will be a good quality investment.

Twyning explains: "The core of what we look to do is ask are these assets good quality, in demand and can they sustain long-term debt?

"You go through a process. Not every housing association you meet appears ready from a governance perspective to take on long-term debt or you may have concerns about asset quality or they may just be running with too much debt. Those are the ones that we don't get involved with."

Aldwyck Housing group raised £40m in a secure debt deal with PIC

Yet, even if a housing association does get into financial difficulty, it is unlikely lenders will take a loss as these difficulties tend to get dealt with by merging the troubled association with a larger, more healthy one.

Twyning says: "What we see as the most likely outcome is a negotiated position with the regulator where the assets and the corresponding liabilities would get moved to a healthier entity."

Competition

While PIC has been investing in the social housing sector for a number of years, there is increasing institutional interest for assets of this type.

Twyning says this demand tends to come in cycles and believes the key is for lenders to maintain price discipline – noting they are not compelled to keep lending if they don't think there's value in the market.

But he says there is also an increase in the number of associations wanting to come to the market to replace or add to short-dated bank facilities.

He says: "I think we have seen an increase in supply and an acceptance that capital markets are probably at least part of the solution, if not most of the solution in terms of long-term funding."

Twyning also notes that, while there may be more investors than in the past, there are still only a few that can write the larger deals – those with ticket sizes of £50m to £100m or more – and fewer still that can offer innovations around things like duration or the deferral of funding, where a proportion of the loan is provided at a point in the future.

He explains: "A lot of housing associations look at where interest rates are now and want to lock in but they don't necessarily want all the cash coming onto their balance sheet on day one as they may not have a current spending need or they may be earmarking it for a refinancing in a couple of years.

"What we find is you are able to negotiate superior terms if you can give them something that is more cost effective for them over the longer term, or makes more sense for their balance sheet."

Long-term

Twyning says that, while these sorts of investments can add significant value, they do require significant work.

He explains: "Unless you're doing it in decent ticket size, I don't think it makes economic sense to do so. So we look at £35m to £40m as a minimum investment size to justify the level of work."

He also says that these sorts of investments need to be seen as part of a long-term relationship – noting PIC is starting to see some borrowers come back to discuss incremental funding.

Twyning concludes: "I think if you are going to get involved, I think you've got to think about the long-term relationship and how that works and the level of involvement you may need to do, both up front but also as things change.

"Clearly these things evolve over time and borrowers may need to come to you to talk about consents or waivers to do things that are slightly outside of the loan documentation – it is not just about making an allocation, it is more of a dynamic ongoing commitment to be involved with the organisations you lend to." PP

How the Pilkington Superannuation Scheme completed a £230m buy-in

Jonathan Stapleton speaks to Pilkington Superannuation Scheme trustee chairman Keith Greenfield and PIC head of orgination structuring Uzma Nazir about the deal

Jonathan Stapleton: What were the key reasons for you undertaking a buy-in and what was the background to this deal?

Keith Greenfield: The scheme, like a lot of defined benefit (DB) schemes, is relatively mature – and closed to new members though not to future accrual. The employer, a glass manufacturing company now owned by a Japanese parent, Nippon Sheet Glass Company (NSG), was keen to work with the trustee to de-risk and minimise any further increases in the commitments it has made to the scheme. So unlike a lot of employers – who perhaps want to keep on risk while the trustee is pushing for de-risking – it was very much about the employer working with the trustee to bring about de-risking.

We'd already done quite a bit of inflation and interest rate hedging; and had also worked on the investment portfolio to get that into a relatively low risk position but with some growth capability.

We had additionally completed a £1bn longevity swap with Legal & General in 2011, which covered all the pensions in payment up to that date but excluded dependents.

However, since then, new pensioners and dependents' pensions had come into payment and longevity risk was increasing again.

And that is the background to the buy-in we conducted last year – we held the view that we had done quite a lot on the investment portfolio; we had reduced longevity risk and there was now was an opportunity to do a bit more.

Jonathan Stapleton: What group of the membership did the buy-in cover?

Keith Greenfield: The buy-in covered all the people whose pensions came into payment after the longevity swap until the point we completed the buy-in last year and also covered dependents.

Jonathan Stapleton: When did you start to think about conducting a buy-in and what steps did you go through to prepare?

Keith Greenfield: We had been thinking about a buy-in transaction since just before the 2015 General Election, when we decided to do some more preparatory work on our data in preparation for a potential deal and look at how many of our pensioner members were married and what was the age of their spouse.

People often don't do a great data gathering on this; they just assume 80% or 90% of them are married and that the spouse is three years younger than their partner. And they just work on those assumptions. Our view was if we could get some more accurate data on that, it might help with a quote.

We decided to write to all our pensioners asking them if they were married and, if they were, how old their spouse was. We got a huge response to this and over 90% of our pensioners responded – giving us some really accurate data.

When we compared these numbers with our valuation assumption, it wasn't that different – maybe an odd million or so worse than what we thought in terms of added liability – but we felt, and our advisers were telling us, that insurers should be able to give us a keener quote because they are not having to make an assumption in this area, they have got some real data to work on. So we felt that was a useful exercise to go through.

And then we came into 2016 and decided to transact. Obviously the EU referendum cropped up in the middle of it but, by this point, we had been through the tendering process – moving from a longlist to a shortlist and had chosen PIC as our supplier. But, as part of the final negotiations, we wanted to try and secure the price as much as we could, locking in the price relative to our gilt portfolio.

The buyout in brief

- The £1.9bn Pilkington Superannuation Scheme concluded a £230m buy-in with Pension Insurance Corporation in the middle of 2016.
- The scheme benefitted from the rise in the value of gilts after the Brexit vote and exchanged them for a buy-in policy, insuring a proportion of its pensioner liabilities.
- The negotiation of a price lock mechanism in the run-up to the transaction enabled trustees to ensure a more certain outcome in the wake of the EU referendum.

"We decided to write to all our pensioners asking them if they were married and, if they were, how old their spouse was. We got a huge response to this and over 90% of our pensioners responded – giving us some really accurate data"
Keith Greenfield

Uzma Nazir: When we were chosen as the provider, there was a period of a few weeks between being selected and contracts being negotiated and actually signed. So there is always a period when the price will change from an insurers' point of view. The trustee wants certainty as to how that will change and we often enter into arrangements where we predefine how our premium is going to move, and there are various metrics for doing that. What we agreed on Pilkington seemed to work on both sides; it worked for us and it worked for the scheme in terms of how it was measuring liabilities.

Jonathan Stapleton: Did Pilkington benefit from market volatility following the EU referendum?

Uzma Nazir: Pilkington was holding gilts for the transaction and our price generally moves in line with gilts and corporate bond spreads. Just after the EU referendum, corporate bond spreads rose quite a lot which meant we could buy corporate bond assets at attractive rates.

Our pricing reflected that and that's what the scheme ended up locking in to – as they are measuring liabilities against gilts and not corporate bonds, then that will be beneficial because our price will have gone down whereas their liabilities won't have changed because of corporate bond spreads. So, Pilkington benefited from that in our pricing and effectively locked in to this pricing just after the referendum.

Jonathan Stapleton: Is there any advice you would offer other schemes looking to conduct a similar deal?

Keith Greenfield: There are a number of things. One is to be well prepared and plan ahead. Don't think you can just do this overnight – it might only be a couple of months from start to finish when you're well prepared and deadly serious but, if you need to get your data in place and understand at what price you are willing to transact, then you have to start planning well in advance. So, be well prepared, plan ahead and sort your data as much as possible.

The second thing is within the trustee board itself. Most boards probably don't move as quickly as perhaps they could so what we did is make sure we had educated the whole board about what we were trying to do – holding a number of different training sessions about what buy-ins were, what buyouts were, what longevity swaps were, what we were doing and why we were doing it.

But then we also set up a much smaller committee, including representatives from the sponsor, that was given authority to move much more quickly. We delegated as much as we possibly could to that, obviously going back to the main board when we had final pricing and deals but we set up separate meetings for that. So having a committee that can move quickly is important.

I think going to tender is also important – it sounds obvious but it creates that competitiveness in the process. So we went from about six or seven in the first round and then we cut it down to two or three after that. I suppose what's surprising is there can be quite different movements between the different parties on the second round as they actually firm up their offers and actually decide if this is a piece of business they want or not. So we actually saw what was seemingly the best offer get usurped by PIC in that second round. I think it is important for the trustee to have that competitive tension in order to secure the best price.

You also need to have an idea at what level you're willing to do the buy-in and to know what level you feel is good value. Going in without that leaves you very exposed because you'll get a price and you have no idea whether that's good value or not and whether or not you are paying too much. So I think doing some preparation about the level at which you're willing to complete a deal is important.

Clearly the use of your main adviser is also important; we used Aon Hewitt, who are our scheme actuary, and we are very pleased with the work they did for us. But I think more important is how all the advisers then work together because you cannot work in isolation just on a buy-in, you have got to work on what's going to happen to your investment portfolio, what investments need to be ring fenced and ready to be passed over and transferred. And therefore it's important that all the advisers, including those acting for the sponsor, are working with each other to make this happen.

I think probably the most important thing is that you have got commitment from your scheme's sponsor, because without that, any transaction will fail. So many trustees go into this saying we want to do a deal and then turn back to the company, which says it is not willing to do it for whatever reason. And there can be all sorts of different reasons – they may not think the pricing is that good; they may be willing to carry more longevity risk. One of the things is that company accounts are driven by IAS19 numbers. And when you do a buy-in, it can have an adverse effect on the IAS19 deficit or surplus because assumptions change. So this does have an impact on the sponsor and they've got to be willing to take a possible hit on their IAS19 numbers and be prepared to communicate to their shareholders and analysts about what's going on. Because the reality is, while IAS19 is just an accounting number, this is a real de-risking issue. So you do need the full support from your sponsor, otherwise it just won't happen.

Finally, I would say you need to be serious about doing the deal and not waste anyone's time here. Insurers get lots of people coming to them for quotes, but maybe some who just want to get a flavour of where the market is. And they have to spend a lot of time doing a quote and a tender and if they do loads and loads of those and nothing ever completes, then it probably becomes very frustrating from their point of view. So I think if everyone is serious about doing a deal, that's when things can happen very quickly and get done to the benefit of all parties.

"You can really tell the seriousness of the proposition by the level of engagement you get from the advisers and the detail you get in the request for quotation that is sent"
Uzma Nazir

Uzma Nazir: I would completely agree. You can really tell the seriousness of the proposition by the level of engagement you get from the advisers and the detail you get in the request for quotation (RFQ) that is sent. I think the best processes are those where it's clearly laid out who's involved in the transaction and whether it's got a joint working party or not, who's going to make the decisions, if the meetings have already been booked in and exactly what their pricing metrics are. And Pilkington had exactly that.

But, as Keith said, we often get quite speculative quotation requests come in where you submit the quote and then you don't hear anything for months and you are not really sure what's happening. And, as an insurer, if you don't know what's happening, you can't really push your board and investment committee to allocate the best assets and the best pricing to it because you just don't know what's happening in the process.

Jonathan Stapleton: What are your future plans for risk reduction?

Keith Greenfield: I doubt we will be doing a buyout in the near term, but we have agreed a longer-term plan of getting to 100% on a technical provisions basis, which is a reasonably strong basis. After that we will look to move to 100% on a valuation basis, which is almost gilts flat, and then look to move to a place that is a bit more than gilts flat.

As we move through those three phases, we would expect the investment portfolio to continue to de-risk until the point we will be holding very low risk-matching assets alongside the buy-ins.

And we will continue to pass more assets over to insurers as more pensioners come on – giving us the certainty of totally matched cash flows coming in to meet pension payments.

So I think that is going to be our way of eventually moving this scheme to self-sufficiency, with very low risk reliance on the company.

The future of DB

The Department for Work and Pensions, parliamentary committees and the broader pensions industry have all been discussing reforms to make DB sustainable for the future. This Q+A discusses some of the key issues

Q **Jonathan Stapleton: Over the past year, we've had reports from the Work and Pensions Committee, the Pensions and Lifetime Savings Association's DB Task Force, as well as a green paper on pensions. Do we really have a crisis in defined benefit (DB) provision and do the challenges require radical and immediate action?**

Mody: I think it's difficult to generalise across a whole industry, to say that we would have a crisis. We have more than 5,700 DB schemes in the universe. For sure, at one end of the spectrum there are some schemes in stress, maybe even in distress, and yes, I think immediate action is needed to avoid worse outcomes a few years down the line. So there is a pocket of the industry that is under some stress and I suppose you could argue, if you wanted to use the word, for that part of the universe it's a crisis.

However, even at the other end of the spectrum – where it looks like you've got companies backing schemes in a completely affordable way – I would question whether what's happening is quite right.

If you've got a company paying several millions into a pension scheme year on year to repair a legacy deficit, is it right that they carry on doing so for a very long period of time? Is it right that that cost becomes part of the furniture for that company, a fixed part of their operating profit and loss? I'm not sure that it is. So while you wouldn't describe that segment as in crisis, I still think there are issues relating to those schemes that would merit review.

"I'm a bit inured to the term crisis. I've been in pensions for a good 20 years and it's apparently been in crisis the whole time"

Rosalind Connor

Connor: I absolutely agree about trying to look at the universe of pension schemes with a little more granularity. I think our legislation and regulation historically has been very much one size fits all and that causes a lot of problems – everything gets a bit lumped together.

I'm a bit inured to the term crisis. I've been in pensions for a good 20 years and it's apparently been in crisis the whole time.

Saying this, I do think there are schemes that are in a lot of trouble, although I'm not sure anyone can pinpoint exactly which ones those are. And I do agree there is this real problem that we assume that anyone who is not putting the money into the pension scheme is doing something bad. Well, maybe they're investing in the business. Maybe they're looking to the future. And yes, even paying dividends allows you to get more investment in the future; if you can't pay dividends because of your pension liabilities, then people won't invest in you.

That in itself is a problem. I think we need to see pensions as part of the broader business environment and make sure that we are not making those companies that did the right thing, and set up pension schemes, suffer unduly.

Shah: As far as members of pension schemes are concerned, it does feel like a crisis. You look at the news flow around the British Steel Pension Scheme and the BHS Pension Scheme and there are clearly issues, which are highlighted in the media. So how do you, as a member of a pension scheme, digest all of that information? I absolutely agree that there is not a one size fits all situation here; different pension schemes are in different positions.

I think there should be better information flow to members to give them more succinct information around the extent to which their pension is at risk, without inundating them with more statistics, more legalistic type of information. So I think one of the things we as an industry should do is to think about exactly what should be communicated to members.

Connor: I agree we need to be careful how we give information out. Historically, there's been a bit of a belief that if we give people information then that sort of democratises everything and suddenly puts everyone in a position to make really intelligent decisions, and even assume that they have decisions to make.

I think there is no harm in people having a better understanding of the risk attached to their DB pension scheme, and having some idea of how big that is. But I do think there is a particular sensitivity about talking about individual businesses and

Panel

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

Rosalind Connor, chair of the Association of Pension Lawyers and partner at ARC Pensions Law

Raj Mody, partner and global head of retirement & pensions advisory at PwC

Jay Shah, chief origination officer, Pension Insurance Corporation

their strengths to members, who have not signed confidentiality agreements and who often don't even work for the business anymore, sometimes working for competitors. If you suddenly start telling people that a business is in trouble, that can cause damage all by itself. So I think we have to be careful how we go about this and make sure that information is generic to ensure you don't end up with it being on the front page of the *Financial Times*.

Mody: I think it comes down to what you communicate and why. So, I would be very averse to any kind of attempt at an assessment, whether it is a traffic light system or anything else, because I'm not sure it's easy to condense the information into a single index measure, especially when it isn't just about the security of your own DB scheme but also about the interplay with the Pension Protection Fund (PPF) and so on.

However, I do think that it's very valuable for members to understand that a DB pension is not a cast iron guarantee. And that is important because should the scheme, trustees or the sponsor need to go and make some interventions, the members can understand the reason this has been done and why there is a need to look again at how to deliver the pension commitments.

For that reason, I would say some communication to help members understand that the DB promise was never cast iron, it was never set in stone, would be helpful.

Q Jonathan Stapleton: Should there be different regulations for different sorts of schemes, perhaps a different regulatory regime for very underfunded schemes and those that are better funded?

Connor: The problem with this, and the problem the PPF has when it has set its covenants for the purpose of the levy, is that there are always people at the edges. And part of the problem is that you are measuring more than one thing. I always get very nervous about regulation being too prescriptive and not allowing leeway.

I would rather have regulation that allowed flexibility, that's how law works best. If you look at what we have with, say, the regulated apportionment arrangement (RAA) regime at the moment, a slightly odd arrangement which allows a business to separate itself from its scheme, it can only be done if the employer can convince the regulator and the PPF that it's the right thing to do.

So what you have is a regime that isn't written in terms of different categories having different rules applying to them, but you have a body that has to approve it if they think you fall into the right category. To me, that is the best way to go.

You do need, I think, to have a regime that allows flexibility – and the more flexible bits of our present regime work an awful lot better than the fixed bits.

Indeed, I would like to get rid of some of the bits of the regulation that is not flexible. The older bits of our regime, most of the 1995 Act for instance, is not flexible and it comes from a different time.

People come back often to section 67 and its counterpart, section 91, which is about members not being able to give up benefits. I think both of these are very laudable ideas, but possibly ones that need to be looked at again.

Q Jonathan Stapleton: To what extent do you believe consolidation could help schemes access lower cost, more sophisticated investment strategies and potentially improve governance?

Shah: Well, I'd suggest all the tools are already in place – we have a number of large administration providers; and there are a number of large providers of investment services, whether that's trustee-chosen investment strategies or fiduciary management. Also, close to my heart, we have insurance-based solutions, such as buyouts and buy-ins. So I think all the tools for consolidation are already there and perhaps we should be making more use of these.

Mody: So I think you need to break down this debate between the goals of are you trying, as a sponsor or trustee, to reduce risk or are you trying to attack cost in your operating cost?

If you are trying to deal with risk, you need some kind of transaction that discharges you from that liability and, as has already been said, there is already a market that allows you to do that through buy-ins and buyouts.

If you're trying to attack cost, there may well be more efficient ways of administering your scheme, investing your scheme and so on, and efficiencies that come from scale. And there are also technology systems that can start automating some of the number crunching, the advisory work, as we know.

But these options are already available, so I would tend to agree with Jay that there's a long shopping list of things schemes can do already to tap into greater efficiency.

Connor: I think it depends what you are going to do with your mega funds. Some of what the PLSA seems to be talking about in its suggestions seems to convey the idea perhaps of consolidating and simplifying benefit structures as part of that. Now I can see that there is specifically a cost saving there and there are an awful lot of pension schemes out there that have a dozen or more different benefit structures.

In such schemes, the risk of mistakes is obviously much higher; the difficulty in actually doing any assessment of the liabilities is increased. So if you could have everyone on a similar basis, I can see that that will save money. Of course that needs

"Risk carries a cost and if you want to reduce risk, there's a cost attached to it"
Jay Shah


L to R: Jonathan Stapleton, Jay Shah, Rosalind Connor and Raj Mody

legislation and I don't think that is going to happen any time soon.

But there must surely be some solution out there for businesses that want to reduce risk which is not the buyout market. There must be somewhere in the middle for those schemes that are reasonably decently funded, but not to a buyout level.

Shah: Risk carries a cost and if you want to reduce risk, there's a cost attached to it. If we're trying to find something that sits between the existing DB infrastructure and insurance companies, that in effect means moving to a less risky regime than under current DB provision, but more risky than insurance companies, because the cost is all associated with moving from a risky to a low-risk or a zero-risk environment.

So what I would suggest is that any discussion or development around this middle ground also focuses on what's an acceptable level of risk? What's the cost attached to it? And who bears any residual risk?

And we talk about innovation, but there is nothing really stopping trustees coming to an insurance company and saying they only want to insure certain risks and keep hold of the residual risks.

That's entirely possible under an insurance contract and we've actually done that with a number of schemes – a simple pensioner buy-in is an example of that; pension schemes have decided they want to insure their pensioner liabilities but not the rest of the scheme.

So those solutions are already there. The key issue is what's the risk that's left with the pension scheme and who is bearing that risk.

Q **Jonathan Stapleton: I would like to move on to the restructuring of benefits. Do you think this is either desirable or achievable?**

Connor: I think there is a lack of political will of addressing the concept of the pensions promise – and the idea that you do not promise people something and then walk away from it.

This sounds obvious but the pensions promise is then used to mean every single minute detail of the benefits you provide – and I think there is a great difference between the general idea of the pension promise and the minute detail about risk benefits, about increases, discretions and whose discretion it is whether you get an increase on early retirement or not. Those are not things people are necessarily thinking about when they say the pensions promise.

I'm not necessarily saying we have to start attacking the edges of the pensions promise and give people the ability to change those benefits, but I do think we need to have a more intelligent debate than the one we've had historically, which has been largely saying if you've promised that to people, you can't try and get out of it.

Mody: One example is on the topic of indexation and the debate about the use of RPI or CPI.

I think this is a good example of where you can lose sight of the aim of what pension schemes were trying to do in the first place, or indeed what overriding government regulation was trying to do.

Some commentators will talk, for example, about a potential move from RPI to CPI as meaning that members lose out. That is one way of looking at it.

But many sponsors and trustees look at it another way, which is not so much thinking that the members lose out; but thinking that they won't get an additional windfall, which was never intended to be the point of that benefit description in the first place.

So I think it's quite important when you're looking at these future restructurings to just go back to the first principles of what you were trying to achieve originally. I think the circumstances will depend on each scheme but, in the case of indexation for example, would giving CPI as an appropriate measure of forward indexation necessarily be the wrong thing to do? You may be prevented from doing it for all sorts of reasons to do with your rules and case law but that, I think, is a debate that needs to unfold.

Shah: I think it's absolutely undeniable that the pension promise is worth a lot more than it was ever envisaged it would be when it was granted. We're living in a low interest rate environment which means the pension promise is worth more – I think that's absolutely undeniable and that's why, increasingly, future DB provision is frankly unaffordable.

But is there the political will to change that? We talk about pensions simplification as if it's naturally the right thing to do and in everyone's interest but of course simplification means some people are going to be better off and some people are going to be worse off.

We might argue that those people who are worse off receive what they thought they were going to get anyway. But you get into this quite complicated situation around how you legislate and what level of simplification is appropriate.

Q Jonathan Stapleton: We have heard a lot from all of you today about the small niggly things. Rather than these very big and bold reforms that have been mooted over the past year, do you think we need a great series of minor reforms instead?

Mody: I see it as a two-track strategy. Absolutely dream big – and it's great to innovate for the big solutions that might ultimately deliver some huge step change improvement to the industry, but I see those as several years down the line. In the meantime, let's keep going with the right kind of regulation, maybe it's deregulation in some cases, to allow pension schemes to operate more effectively year by year.

Connor: I had one thing in my mind when I was lucky enough to be in front of the Work and Pensions Committee late last year on behalf of the Association of Pension Lawyers, which was to do everything I could to stop them trying to pass more laws.

We have so much legislation on pensions, it's ridiculous. And people only ever come up with big dreams. They don't look at the detail, they don't tidy up what was there before, they just overlay it with something else that doesn't actually get rid of what was there before. If I was dictator of the universe, the one thing I would do is tell the pensions minister he is not allowed to change any big law, he just needs to sort out the stuff that's already there. And he needs to do that for 15 years before we'll have a system that works properly.

"Simplification means some people are going to be better off and some people are going to be worse off"
Jay Shah

Shah: I don't know. One of the issues the pensions industry faces is having to react to small changes. I just wonder whether - if we're not going to see a big bang change and I don't think we will – whether the pensions industry should just have a period where not a lot changes – where we don't have tinkering with legislation; we don't have another raft of things to worry about; and we actually try and sort our house out.

I think we have a system which is overly complex and layering on more legislation is going to make it more complex rather than less.

Q Jonathan Stapleton: We're coming towards the end of our debate. Can I ask each of

you to conclude with the following question: Given the amount of reform being discussed currently, how do you believe pensions will change in the coming years? What does DB 2020-2025 look like, in your view?

Connor: I think, from a regulatory point of view, nothing will change before 2020. There just isn't the parliamentary time. Perhaps the Brexit process, and a few years of not doing anything will allow us, as Jay was saying, to get our house in order and perhaps that's no bad thing.

I'm not sure that 2020-2025 will see things very differently from where they are now. The process of schemes going to buyout is slow; schemes are running on.

A couple of businesses will go bust, rarely because of the pension scheme, if the PPF is to be believed. But schemes will carry on and the present regime will wander on and perhaps in somewhere by 2030-2040 we will see some serious changes but I would think, in the next five to 10-year period, not so much.

Mody: I would be inclined to agree with that. I don't think DB 2020 will look radically different at all and probably nor will DB 2025. What I do think will happen though is that we will see a continuation of what has started in a very small way with the DWP's green paper, and no doubt there'll have to be a white paper that follows that and takes the points further forward.

But what it has done in a small way is to legitimise that there is a debate to be had around a wide-ranging set of issues. Even if you broke them all down, there's still about a dozen issues in that paper that are now on the agenda.

I think that the industry, absent any overriding reform to help them along their way, will continue to debate those points, shape what possible solutions are available, often of their own accord and through voluntary means rather than with any external help, and we will just see a gradual progress against those issues over the next decade or so.

For example, one theme in the green paper was around the flexibilities the DWP believes that pension schemes and employers already have when it comes to funding their schemes. It's legitimate to shine a light on those existing flexibilities which, in my view, are not generally deployed as widely as they could be.

So I think we will see a gradual move towards schemes and companies adopting and understanding some of those flexibilities, and so on. But it will be a largely voluntary, largely scheme-by-scheme journey, provoked by the debate that the industry as a whole is having. But I don't see any great solution coming down the pipeline.

Jay Shah: I'd agree that we shouldn't expect any fundamental changes to DB pension schemes although I am actually quite optimistic.

I think we will see a series of gradual changes across the landscape. First, I think there'll be a greater level of professionalism brought to the running of these pension schemes – with the people who are making the decisions, both companies and trustees, having a fundamentally better understanding of the economics of the pension schemes, as well as how they operate on a day-to-day basis. That's number one.

Second, there will be a much greater understanding of the risks that pension schemes are running, the risks that the trustees or the company are willing to continue to run, and understanding what risks can be hedged out, either through the various instruments in the market or buy-ins or buyouts.

And finally, I think I am optimistic about a better appreciation among the members of pension schemes about what exactly they've been promised; a realistic understanding around the risks of that promise being fulfilled; and maybe a greater understanding around what they might be asked to give up in the future, in the medium term, for greater security of what's left. PP

"It will be a largely voluntary, largely scheme-by-scheme journey, provoked by the debate that the industry as a whole is having"
Raj Mody

The purpose of finance

In March, David Pitt-Watson and Dr Hari Mann published a paper looking at why finance matters and how the industry can improve. *PP* summarises the key points

Last April, Pension Insurance Corporation (PIC) hosted a lecture where London Business School executive fellow David Pitt-Watson asked the questions "what is the purpose of finance?" and "how well does it fulfil that role?"

This seminal lecture sparked much debate and has led to the development of a broader "Purpose of Finance" project, backed by PIC, which aims to facilitate a long-term discussion and help develop a new "common sense" perspective from which to evaluate performance that can help policymakers and industry participants guide the future development of our financial system.

In April, Pitt-Watson and Dr Hari Mann published a paper - *Why Finance Matters: Building an industry that serves its customers and society* – to launch the project and look at some of these issues in more depth.

> **"What little evidence we have about finance is sobering. It suggests that, in terms of the service which the industry gives to the outside world, there has been no improvement in its productivity in over 130 years"**
> **David Pitt-Watson**

Is the industry doing a good job?

In their paper, Pitt-Watson and Mann observe that little has been done which systematically seeks to answer the question of whether the finance industry does a good job.

The authors point towards one notable piece of research from New York University professor of finance Thomas Philippon, which measures the productivity of the finance industry in intermediation.

In his research, Philippon tried to do a calculation to work out what productivity improvement the finance industry in the US had delivered to the real economy in the past 130 years.

He worked out, from GDP statistics, how much the finance industry had cost, and how much had been borrowed from, and then invested in the outside world, excluding borrowing and lending among financial institutions themselves and controlling for how complex the lending was.

It would be expected that, over the past 130 years in the US, there should have been very considerable improvements in productivity – after all, on average, productivity in the US has grown tenfold over the same period.

However, Philippon found there had been no improvement whatsoever and, even when "quality adjusting" for the greater complexity of lending today, the cost of intermediation had not fallen.

Pitt-Watson says: "In finance, it feels a bit like the world of medicine 200 years ago, when there were great debates about how much blood should be let from an ill patient, but almost no studies of whether or not the practice had a beneficial effect.

"What little evidence we have about finance is sobering. It suggests that, in terms of the service which the industry gives to the outside world, there has been no improvement in its productivity in over 130 years; the system which finances the internet is no more efficient than that which funded the railways."

About the authors

David Pitt-Watson
David Pitt-Watson is currently executive fellow of finance at the London Business School. Until the end of 2012, he was chairman of Hermes Focus Funds and is a former board member of Hermes Fund Managers. As co-founder and former chief executive of Hermes' focus funds and equity ownership service, he built and led the largest responsible investment group of any institutional fund manager in the world.

Throughout his career Pitt-Watson has been deeply involved in policy making in the UK, Europe and around the world, particularly in the area of corporate governance and financial regulation, and is the author of several books on this topic, most recently *What They Do with Your Money*, published by Yale University Press in 2016.

He is also a non-executive at KPMG and treasurer of Oxfam.

Dr Hari Mann
Hari Mann is a professor of strategy and innovation at Ashridge Business School focused on executive education. Through his career, he has worked in academia, investment banking, politics and early stage entrepreneurial ventures.

In 2010, he was made director of Tomorrow's Investor, a project run by the Royal Society of Arts focused on how to deliver better pensions in the UK and is also a visiting fellow at the Cass Business School.

Mann has worked with David Pitt-Watson over the past seven years on a series of publications under the Tomorrow's Investor project. These have focused on how to deliver a better pensions architecture in the UK, how to lower investment costs in UK pensions and what the UK can learn from other countries in the world around pension fund management.

His other research is focused on the areas of strategy,

Dr Hari Mann adds: “Few within the industry have been curious enough to ask the question about purpose. But we have also been too ready to apply simplistic views of market and competitive forces, without considering how and why they work.

“To be clear, to believe that, in aggregate, competitive forces are working productively in the finance industry is at odds with the evidence. Like the very best doctors of 200 years ago, professionals in finance understand that all is not well. They can see the profound importance of the financial system and that a better system is possible. But unless we reframe the debate, based on purpose, we are unlikely to make much progress.”

Asymmetric information

Pitt-Watson and Mann suggest the reason for this lack in efficiency improvement may lie in what economists call “asymmetric information”, where a party to a transaction, usually the supplier, can use their greater knowledge to profit at the other’s expense.

They say asymmetric information exists in many industries, and if markets and institutions are not well designed to cope, it distorts the ability of competitive forces to deliver value – and cite several examples within the finance industry of what they call “expensive, but low-purpose activities” such as the opacity of fees, paying for good luck and high frequency trading.

The paper notes there are many mechanisms used in other industries which prevent asymmetric information being used to undermine the effective operation of markets – such as regulation, education, ethical practice and fiduciary duty – but say that, within the finance industry these have either failed to work or have been overlooked.

As such, they say we should not be surprised if the incentives within the industry and the behaviour of its participants are dysfunctional.

Pitt-Watson and Mann suggest the issue should be addressed by, firstly, defining purpose, both for the industry as a whole, and for individual institutions such as banks, pension funds, stock exchanges and so on – allowing people to measure their performance against these purposes.

Indeed, they suggest the benefit of doing so could be profound – citing private pensions as an example where a more purposeful system could offer better retirement incomes, encourage savings and stimulate the economy to create more jobs and prosperity.

The purpose of a pension

In their paper, Pitt-Watson and Mann define the purpose of a pension as being “to provide a predictable stream of income from the time an individual retires until the time they die and provide thereafter for any dependents”.

They say a pension is of value to everyone, but explain that it is of essential importance to those who may retire without many assets, since if they do not have a pension, and if they live for a long time they may run out of money and be unable to support themselves.

But they say that as pensions are expensive, people are only able to afford one if there is an effective system of savings – and note that they will only be effectively provided if people are able to share longevity risk through an insurance product.

Pitt-Watson and Mann say such products are long-term – as people saving for pensions will need to save over a very long period of time – and note that, because of the long-term nature of these products, levels of return and charges make a big difference.

> **“We have been too ready to apply simplistic views of market and competitive forces, without considering how and why they work”**
> **Dr Hari Mann**

A purposeful pension

Pitt-Watson and Mann's paper suggests that a "purposeful pension institution" might have the following ten characteristics:

1. It will have an effective return seeking savings system into which the saver can put their money

2. It will pool longevity risk effectively

3. It effectively moves capital through the economy, investing in assets, or a series of assets which give a real return over the long term

4. It has clear and appropriate actuarial information

5. It is, and is felt to be, trustworthy

6. It is able to offer a degree of flexibility in the promise it makes and hence is able to accept a degree of flexibility in its investment returns to allow them to be higher

7. It has low costs, and is likely to be exploiting scale economies

8. It is adequately capitalized and/or flexible in its promises

9. It operates within an effective and appropriate regulatory regime

10. It has fairly aligned the interests of policyholders with those of shareholders and other stakeholders

For instance, they note that someone achieving a 4% real return over 60 years of accumulation and decumulation, will receive a pension one third higher than someone who achieves a return of 3%. Likewise, someone who incurs charges of 0.5% will enjoy a similar one-third uplift when compared to someone paying 1.5%.

The paper says there are two critical judgments that need to be made in offering a pension. One is to correctly predict death rates – noting that if all policyholders unexpectedly live an extra twenty years, pension expectations will be difficult, indeed impossible, to keep.

The second judgment is the return that will be achieved on the money set aside. Typically subscribers save over many years, and expect that the returns from that saving will substantially augment their pension.

But the authors say these two issues create a dilemma – if the pension provider wants to make a promise that is certain, that will constrain them to invest only in "risk-free" assets that give a poor return. On the other hand, if they invest in assets whose value might fall, their policyholders need to understand this, and to trust that the insurer will not use "sleight of hand" to benefit themselves by taking a disproportionate amount of whatever return is made.

Pitt-Watson and Mann say this means that building trust into a pension system is critical – noting that if a provider needs to take risk in order to provide a better pension, the saver needs assurance that, at all times, they will act professionally, and only on the saver's behalf.

> **"The problem is that, at that point there is no sensibly priced pension available to purchase and these DC savers have no vehicle which can fulfil the primary purpose of a pension"**

The first pension fund

The paper says it is intriguing to note how these characteristics were first achieved – saying the first pension fund was established, not by a financial institution, but by two Church of Scotland ministers, Robert Wallace and Alexander Webster, in the 1740s.

The subscribers to the fund were other Church of Scotland clergymen and actuarial information was put together by statistical studies undertaken by the church, informed by developments in statistical theory, and overseen by the professor of mathematics at Edinburgh University. Trust derived from the fact that both promoter and beneficiary were clergymen and the payouts from the fund could be and were varied.

Pitt-Watson and Mann say that, for most people today, it is difficult to secure a retirement pension through a system that, like Wallace and Webster's, is both flexible and efficient.

Instead, they say UK pensions have bifurcated into two systems – defined benefit (DB) and defined contribution (DC) – and, while the former are organised collectively, and still offer a pension, they are only allowed to operate if a third party, usually the employer, is willing to underwrite the pensions which are to be paid.

This, they say, has made the liability both rigidly defined and very costly, meaning it has been abandoned by many private sector companies.

On the other hand, Pitt-Watson and Mann say that DC pensions do not fulfil the purpose of a pension scheme. The paper explains: "On our definition of purpose, DC is not a pension. Rather it is a savings plan, which can be realised at the point of retirement.

"The problem is that, at that point there is no sensibly priced pension available to purchase and these DC savers have no vehicle which can fulfil the primary purpose of a pension, since there is no way to share longevity risk, or at least not at a reasonable cost."

Pitt-Watson and Mann say that effective, flexible pensions are still available in countries such as Denmark or The Netherlands – offering schemes that pool longevity risk; are managed by trustees, who owe loyalty only to beneficiaries; are of a scale to minimize costs; and, have good regulators and strong actuarial advice.

These schemes are often able to offer some flexibility in the pensions they pay – with pensions falling by around 2% in The Netherlands in response to the 2008 financial crisis.

Pitt-Watson and Mann say this system – known as Collective Defined Contribution (CDC) – could give pensions which are about 30-40% higher than the DC system currently becoming the norm in the UK.

They conclude: "CDC is recognised as extremely effective in fulfilling the purpose of a pension. It also illustrates the degree to which the design of our financial system has failed to take purpose into account.

"In the UK, CDC pensions are effectively illegal, as regulations have been put in over many years, each aimed at some form of consumer protection, which prevent the flexibility needed for such pensions to operate. In establishing these, regulators were doubtless acting in good faith.

"Sadly they failed to start by thinking about 'the purpose of a pension', or the governance necessary to make such a purposeful system work." PP

To download Pitt-Watson and Mann's paper, *Why Finance Matters: Building an industry that serves its customers and society*, go to: www.pensioncorporation.com