Derisking balance sheets is a priority for most finance directors, **says Amarendra Swarup**, and buyout can be attained through an increasing number of routes

ONE RUNG AT A TIME

Today's finance directors are often faced with the problem of maintaining a set of financial commitments made in another era, when assumptions and expectations were vastly different. These commitments are difficult to measure, let alone anticipate, and they are now tied to the health of the corporate sponsor, which is legally required to underwrite any deficit.

Though their relationship in the past has resembled awkward teenagers staring mutedly across the dance floor, corporate sponsors and pension schemes can no longer choose to shyly look away. Sponsors are increasingly finding a host of unintended and poorly understood risks on their balance sheets.

As people live longer, the immediate calculable costs can rise dramatically as outdated longevity assumptions are updated. Regulatory scrutiny has also increased, with the Pensions Regulator pushing schemes to adopt more realistic mortality assumptions. Even the assets are not immune, as many UK pension schemes have more than half their assets in equities.

It's a growing headache for many finance directors, for whom such risks often lie far from familiar territory and who are charged with looking after a broad church of stakeholders, not just pensioners. As the corporate sponsor, they have an obligation to fund these unexpected growing costs, despite having little or no say in the investment of the scheme's assets. The waters are muddied further by sometimes out-of-date actuarial assumptions that can present a less-than-prudent valuation of the true costs of fully funding the scheme's liabilities. The impact can go far beyond the immediate cash flow hit, filtering through to the P&L, lowering profits, increasing leverage and ultimately, impacting the share price.

This can have dramatic effects on the room for corporate manoeuver and, in the end, on the security of their pledged commitments to pension scheme trustees, existing pensioners and future beneficiaries. So how can responsibilities be met?

Insurance buyouts

One answer is to pass the risk and responsibility of meeting the pension promise to a specialist third-party pension solutions provider. A pension insurance buyout is a bulk annuity policy secured with an insurer that ensures all benefits are met in exchange for an upfront premium. Buyout, followed by a scheme wind-up, is a tried-and-tested method of attaining a complete liability discharge for the sponsor and trustees. The only risk remaining for the members is that of insurer default, and this should be mitigated due to insurance regulation, risk management and the mandatory provision of the insurer having prudent reserves to protect solvency.

It's a win-win situation for everyone. Buyouts can often improve the situation for scheme members as these specialist companies are tightly regulated, operate within strict investment and asset liability guidelines, and are required to hold capital against any extreme losses. It also helps troubled sponsors: securing pension liabilities away from balance sheets improves their ability to raise finance and removes the situation where, in a falling equity market with a commensurate fall in the valuation

of a scheme's assets, a sponsor looking to invest in the business might also find trustees coming cap in hand.

However, this route is expensive and may necessitate a cash injection from the sponsor. This may make it unaffordable for many schemes, as their funding position is too far from buyout and their corporate covenant too weak to bridge that divide. But there are alternatives that can help trustees increase security for scheme members and eventually get them to full buyout.

The simplest way is to execute a partial insurance buyout for some scheme liabilities, such as current pensioners. This can allow a pension scheme to get to full buyout in stages and spread the cost over time, as assets and the sponsor's finances allow. Trustees need to be careful that the premium required does not suddenly trigger a massive deficit for remaining uninsured members. One way to avoid this is by buying in an annuity policy for pensioner members. This means that in the event of sponsor insolvency, the policy would be an asset of the scheme, ensuring all members are treated equitably.

Corporate solutions

If purchasing an annuity overshoots the budget, there are now innovative corporate solutions to help transfer risk. Many sponsors that cannot immediately buy out without a significant cash injection (the majority, as there is no requirement to fund to the buyout level) want to reduce the risk of the scheme. Shareholders are likely to share this view: continued contributions to a DB scheme may not be in their interests, especially if the investment situation subsequently improves and a surplus becomes trapped in the scheme.

Demand for non-insured solutions can be driven by pension schemes themselves, particularly if a scheme has a real or perceived deficit that can only be made up over some years. The danger for trustees is that meeting the pension promise depends on the continued prosperity of their sponsor.

One option is a non-insured pension risk transfer or 'corporate scheme adoption', which is typically designed in a bespoke way. The sponsor is either purchased with the pension plan attached, or an acquirer becomes the new sponsor directly. It is key to ensure that any structure provides additional security for members and does not result in scheme abandonment. Therefore, a non-insured pension risk transfer – where the transaction actually increases the value of the sponsor covenant either by replacing the sponsor with a stronger sponsor, or by adding assets contingently or directly to the pension scheme – avoids this dilemma. It also has a higher chance of being cleared by the regulator.

This solution fills the middle ground between corporate sponsors that are strong and can afford pension insurance, and sponsors where the corporate covenant is very weak and of concern to the regulator and the Pension Protection Fund. Small operating firms with large legacy schemes attached may also be potentially attracted to this form of pension risk transfer. However, many sponsors and trustees are only looking at the immediate road ahead. They will want to reduce the risks, without necessarily severing the link between the sponsor and the pension scheme. Here, the focus needs to be on managing both the assets and the liabilities. Trustees and sponsors can implement bond or swap-based hedging strategies to nullify the impact of interest rates and inflation on their liabilities. This allows them to derisk the pension scheme and focus on growing the assets until they are at a stage to afford either partial or full insurance buyouts.

Much of the recent innovation in the pensions field has been devoted towards providing stepping stones towards full buyout

Many schemes lack the skills and quality of advice to identify and quantify all their risks accurately. Key risks are often not sufficiently understood. Imperfectly hedged, the recent downturn in the global economy and financial markets means many schemes that were slowly pursuing a path towards an insured buyout may never get there.

Some may choose to delegate the holistic management of all the scheme's assets and liabilities to a third-party fiduciary manager. These specialists will typically hedge all the liabilities where possible and diversify the assets among a range of best-of-breed providers, while maintaining a watchful eye on all risks within the scheme as a whole. This ensures the funding position is improved and its ultimate targets are reached in an efficient, structured manner. The approach has proved popular in countries such as the Netherlands, where it has significantly improved funding positions.

The problem is that the solutions outlined in the previous section contain no direct protection against longevity improvements, with only pension buyouts providing the ultimate cover for a scheme sponsor. However, there are now products available that aim to decouple this crippling idiosyncratic risk from the investment risk in a cost-effective manner for those schemes that wish to retain management of their assets. This can allow a pension scheme to fine-tune its risk budget and ensure the larger part of a scheme's risk – its volatile liabilities – is better constrained, while freeing up valuable capital to invest in returning seeking assets and improve the funding position. Longevity solutions can also be used as the final piece in a derisking process, which can allow schemes to be managed with limited volatility.

The latest breed of products allow pension schemes to insure only the longevity risk of pensioners. These products can be scheme-specific, covering pensioners and their dependants for their entire lifespan. This caps the exposure of the liabilities to future longevity improvements and may even increase the chances of a buyout further down the line by potentially reducing the cost.

Pension insurance buyouts and their alternatives may be attractive to many sponsors and trustees. Cost will usually be the critical factor in any decision and much of the recent innovation in the pensions field has been devoted towards providing stepping stones towards full buyout. It is important to think about each step as part of a continuum and ensure each solution is really tailored to the specific needs of the trustees, their sponsoring company and the funding position of the scheme.

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