DB SOLUTIONS InSights

THE BEATLES AND PENSION RISK TRANSFER

The UK has a long history of creativity and innovation in the music industry – the Beatles being a famous example. Their innovation in the pension world is perhaps a lesser known fact, but worthy of singing its praises.

Developments in de-risking solutions for defined benefit (DB) plans – including pension risk transfers from the plan sponsor to an insurance company – are innovations that Canadian plan sponsors can now also benefit from.

We are pleased to share key findings from a recent UK visit that included meetings with leading insurance companies, investment banks, reinsurers and consulting firms. We would like to thank everyone we met for their insights on developments in de-risking solutions.

Sun Life Financial

HELLO GOODBYE – A DRAMATIC SHIFT

The UK pension market has changed dramatically over the past 10 years. The average equity allocation is now 50% from over 70% at the end of 1999[1].

In addition, there are a growing number of innovative de-risking solutions that are making headlines – with almost CAD 30 billion of assets invested in such solutions with insurers over the last three years[2].

Three catalysts have propelled UK DB plans down the road of de-risking:

1. **Pension reform and increased costs**. Higher costs brought about by regulatory changes in 1995 and 2004 that mandated increases to pensions in payment.

2. **International reporting standards**. Greater levels of balance sheet and earnings volatility from an equity-biased asset mix following the adoption of international reporting standards.

3. **Market volatility**. Volatile financial market returns that highlighted the challenges of the "cult of the equity" preference of UK pension plans.

UK companies are also de-risking in a more profound way – by closing access to DB plan membership for new employees. One recent survey of a broad sample of plan sponsors indicates that 87% of DB plans have closed to new members[3].

BY THE NUMBERS – UK PENSIONS

£17 billion

Assets invested by UK pension plans in insurance company de-risking solutions over the last three years

£64 billion

Size of pension deficit of the largest 100 UK listed corporations

87%

Percentage of UK DB plans closed to new members

£1 billion

Value of the Cable & Wireless UK pension buy-in transaction with Prudential

Here's a closer look at the three catalysts that have helped transform the UK pension market.

CATALYST 1: PENSION REFORM AND INCREASED COSTS

The requirement to provide increases to pensions in payment came out of the Pensions Act of 1995. The Act was introduced to improve the running of UK pension plans, largely in response to the embezzlement of significant money from the pension plans of the Mirror Group of Newspapers. For most plan sponsors, however, it was the additional cost in retiree liabilities, and not the extra governance burden, that was a cause for concern.

The Act was superseded by the Pensions Act 2004, since many believed the earlier legislation had failed to offer adequate protection to plan members in wind-up situations. The requirement to provide increases to pensions in payment remained, albeit with some adjustments to future rates.

CATALYST 2: INTERNATIONAL REPORTING STANDARDS

Listed companies in the UK have been required to prepare their financial statements in accordance with International Financial Reporting Standards (IFRS) since 2005. As a result, pension plan assets and liabilities are recognized on the balance sheet, leading to increased transparency of changes in the funded status of a pension plan.

For example, the largest 100 UK listed corporations had a combined pension fund deficit of £46 billion at September 30, 2006. This had changed to a surplus of £18 billion by September 30, 2008 and then changed again to a deficit of £64 billion by September 30, 2009[4].

CATALYST 3: MARKET VOLATILITY

A contributing factor to the volatility of pension funding has been the "equity cult" of UK pension plans. In 1999, the average UK pension plan equity allocation was over 70%. The combination of equity market declines and plan sponsors cutting back equities has seen the average equity allocation decline to less than 50% by mid-2009[5].

DE-RISKING SOLUTIONS TAKE HOLD

While the reduction in equities represents a significant shift, the averages disguise even more substantial changes by some UK plan sponsors by adopting three main de-risking solutions.

Solution	Description	Recent Company Examples
Buy-out[i]	The purchase of an annuity contract that transfers the pension plan's liabilities to the insurance company.	**Delta PLC** A £459 million pensioner buy-out[6]
Buy-in[ii]	The purchase of an annuity contract as an investment to match some or all of a pension plan's liabilities and reduce risk. The liabilities remain in the pension plan and the plan sponsor retains responsibility for them.	**Cable & Wireless** The buy-in transaction was valued at a little over £1 billion and made with Prudential plc[6]
Longevity hedge	The purchase of an investment to remove or reduce the cost of pension plan members living longer than expected.	**Babcock International Group** Longevity swaps valued at approximately £750 million were entered into with Credit Suisse to cap the exposure to the effect of increasing life expectancy on pensions in payment[7].

i buy-out is equivalent to traditional annuity in Canada
ii buy-in is similar to the Pensurance™ solution established by Sun Life Financial (see www.sunlife.ca/dbsolutions for more information)

For the combined buy-out and buy-in market in the UK, there was a total of £17 billion assets over the last three years (approximately CAD 30 billion).

An emerging challenge to the forecasted growth is Solvency II – a proposed set of regulatory requirements for insurance companies that operate in the European Union. It sets out the economic principles for the measurement of assets and liabilities, which will drive capital requirements for the insurers.

The current draft regulations grandfather buy-out/buy-in business sold before 2012, but business sold after that date would be more costly to the plan sponsor, assuming the insurer passes on the anticipated additional costs.

The interest in longevity swaps increased during 2009 with larger pension plans adopting a Do-it-Yourself (DIY) buy-in solution. The longevity swap is combined with assets invested in a matching bond portfolio.

This approach is facilitated by a relatively large UK corporate bond market (compared to a smaller Canadian corporate market), which makes the cost of hedging the liabilities more comparable to a buy-in solution with an insurance company.

HELP – THE CANADIAN PERSPECTIVE

Some of the factors that influenced the UK DB market place are likely to apply to Canadian pension plans in the near future.

- **Pension reform**. There are two streams of pension reform proposals. The first address concerns expressed about declining pension plan coverage and potential under-saving in pockets of the Canadian working population. The second relates to DB plans and centers on providing financial relief for plan sponsors on one hand, and increasing benefit security for members on the other. This follows several recent high profile corporate bankruptcies with under-funded DB pension plans. While there will be no single solution to the current challenges, better management of DB plan risk relative to a company's ability to meet the financial burden will go some way to appease the regulators.

- **International reporting standards**. IFRS will replace the current Canadian Generally Accepted Accounting Principles (GAAP) reporting standards in 2011. These changes could result in significant changes to the pension disclosures in financial statements, particularly for the company's reported income and balance sheet.

  For Canadian plan sponsors, early adoption of risk transfer, or other forms of de-risking, may be the best way to prevent the large variability in funding seen in UK financial statements over the last few years.

- **Market volatility**. While the recent market downturn has shifted the average equity allocation for Canadian plan sponsors from 60% to 53%[8], there is now more equity risk in Canadian DB plans compared to their UK counterparts – a considerable change in relative risk profiles over a fairly short period of time.

The combination of potential pension reform, new reporting standards and the high level of equity exposure is changing the way sponsors are approaching risks associated with DB plans – with a greater emphasis than ever on de-risking solutions.

CANADIAN SOLUTIONS

There were two significant developments in the de-risk solutions arena in 2009:

1. The use of traditional annuities (buy-out solution) to transfer retiree risks for active DB plans by Canadian sponsors

2. The introduction of a Canadian version of the buy-in solution.

The overall Canadian group annuity business added CAD 1.3 billion in new assets in 2009 – small change when compared to the volume of annuity business reported in the UK, but there was a major shift in the view of annuities in the Canadian DB market. We'll visit a case study for one such plan sponsor who reduced the impact to its balance sheet from the DB plan through the purchase of traditional annuities for the retiree liabilities.

In addition, 2009 saw the introduction of Sun Life Financial's Pensurance™. The unique features of this solution are it provides DB plan sponsors with the ability to hedge retiree investment and longevity risks, but without requiring top-up contributions or having accounting settlement implications that occur with a traditional annuity purchase.

Pensurance™ has similar characteristics to the UK buy-in solution. And while Solvency II regulations currently being considered in Europe could eventually cross the pond to North America, Canadian solutions won't be impacted for some time. While early adopters of this form of risk transfer solution would therefore enjoy greater price certainty, the real benefit would be getting a head start in their risk management journey.

CASE STUDY – RISK TRANSFER IN ACTION

This case study illustrates a transaction in which Sun Life Financial was involved during 2009. Certain details have been changed to preserve the confidentiality of other involved parties.

Company ABC had CAD 500 million in defined benefit (DB) liabilities. Approximately 30% of the liabilities were in relation to retiree liabilities. There was a $100 million deficit.

Pension Plan	$M
Liabilities	
• Retiree	150
• Other	350
Total	500
Assets	400
Surplus (deficit)	(100)
% funded	80%

Having considered a number of risk management solutions, the company went to market to obtain annuity quotes to transfer the retiree liabilities to an insurance company. Since the fund was in deficit, the company made a contribution to ensure that after the transaction the funded ratio remained the same, ensuring fair treatment of all plan members.

The company worked with a consultant to issue a request for proposal to obtain quotes from insurers and perform due diligence on them. The business was awarded to two insurance companies. After the risk transfer, the liabilities were valued at CAD 350 million and the plan remained 80% funded due to the cash contribution.

Pension Plan	Before risk transfer $M	After risk transfer $M
Liabilities		
• Retiree	150	-
• Other	350	350
Total	500	350
Assets	400	280
Surplus (deficit)	(100)	(70)
% funded	80%	80%

Looking ahead, the aging of the baby boomers will impact the company's workforce such that an additional CAD 150 million of retiree liabilities will emerge over the next three years.

The company plans to annually review the value of new retiree liabilities and to follow a similar risk transfer process. So in three years time, the DB plan's liabilities will be valued closer to CAD 200 million compared to the original CAD 500 million of liabilities (not allowing for market returns or other cash flow). The plan sponsor will be impacted by a much smaller dollar risk from the DB plan – with smaller implications to the day-to-day running of the business.

THE LONG AND WINDING ROAD

There is no single solution or quick fix to de-risking Canadian DB plans. While the road to lower risk can be a long one, it's important to start the journey and take advantage of the risk transfer opportunities that are now available – before market volatility or regulatory changes create new cost uncertainties.

ABOUT THE AUTHORS

Brent Simmons leads Sun Life Financial's DB Solutions team. Brent joined Sun Life Financial in 2008, from a strategy consulting firm, where he was a partner and specialized in non-traditional risk and insurance solutions. Prior to that, he was a Principal at one of Canada's leading pension consulting firms.

Peter Muldowney has more than 20 years' experience in the pension and investment consulting industry as a consultant, marketer and strategist. Peter has held senior roles in leading Canadian and UK consulting and financial services firms.

Annuity solutions are provided by Sun Life Assurance Company of Canada, a member of the Sun Life Financial group of companies.

ABOUT SUN LIFE FINANCIAL

Sun Life Financial is a leading international financial services organization providing a diverse range of protection and wealth accumulation products and services to individuals and corporate customers. Chartered in 1865, Sun Life Financial and its partners today have operations in key markets worldwide, including Canada, the United States, the United Kingdom, Ireland, Hong Kong, the Philippines, Japan, Indonesia, India, China and Bermuda. As of December 31, 2010, the Sun Life Financial group of companies had total assets under management of $464 billion.

Sun Life Financial Inc. trades on the Toronto (TSX), New York (NYSE) and Philippine (PSE) stock exchanges under ticker symbol SLF.

For more information, please contact:

Brent Simmons
Senior Managing Director
Defined Benefit Solutions
T. 416-408-8935
E. brent.simmons@sunlife.com

Heather Wolfe
Assistant Vice-President
Defined Benefit Solutions
T. 416-408-7834
E. heather.wolfe@sunlife.com

[1] National Association of Pension Funds (NAPF) Annual Survey of UK Pension Funds.
[2] There was a total of £3 billion assets placed in 2007 and £8 billion in 2008 (Source: Pension Capital Strategies Ltd) and based on discussions with market participants and advisors in the UK, 2009 will see another £6 billion, which implies approximately CAD 30 billion over the three years.
[3] Survey conducted by the Association of Consulting Actuaries (ACA), which was carried out during June and July 2009. The Survey was completed by 309 firms with combined assets of £139 billion.
[4] Pension Capital Strategies Ltd ("PCS")
[5] National Association of Pension Funds (NAPF) Annual Survey of UK Pension Funds. The 2009 Survey is an analysis of 300 NAPF scheme members operating defined benefit, defined contribution and local authority pension schemes covering over £410 billion in assets.
[6] Lane Clark & Peacock LLP Pension Buyouts 2009
[7] Babcock International Group PLC press release – Pension Liabilities Gap, 26 June 2009
[8] RBC Dexia Canadian DB Plan Universe (December 31, 2009)