What's your end game?

End game Solutions for Defined Benefit Schemes

What’s your end game?

As investment markets recovered from the financial crisis of the last decade, many defined benefit pension schemes’ funding levels improved.

Economic growth and company earnings underpinned an improvement in the financial health of both companies and their defined benefit pension schemes, bringing the discussion of pension scheme end targets into sharper focus.

But what is the ‘right’ end game?

- Should the target be full funding on a self-sufficient basis, making the scheme a stable low risk entity on a company’s balance sheet?
- Should an extra premium be paid to an insurer in order to offload or match pension scheme risk?
- Does a middle ground exist that provides the best of both worlds?

The answer is usually different for each scheme and depends on their specific circumstances. With this in mind, we put end game solutions under the microscope, using real case studies from SEI clients to demonstrate how these solutions might work in practice. As we will see, it’s clear that in every case the end game solution should be customised to the needs of each scheme.

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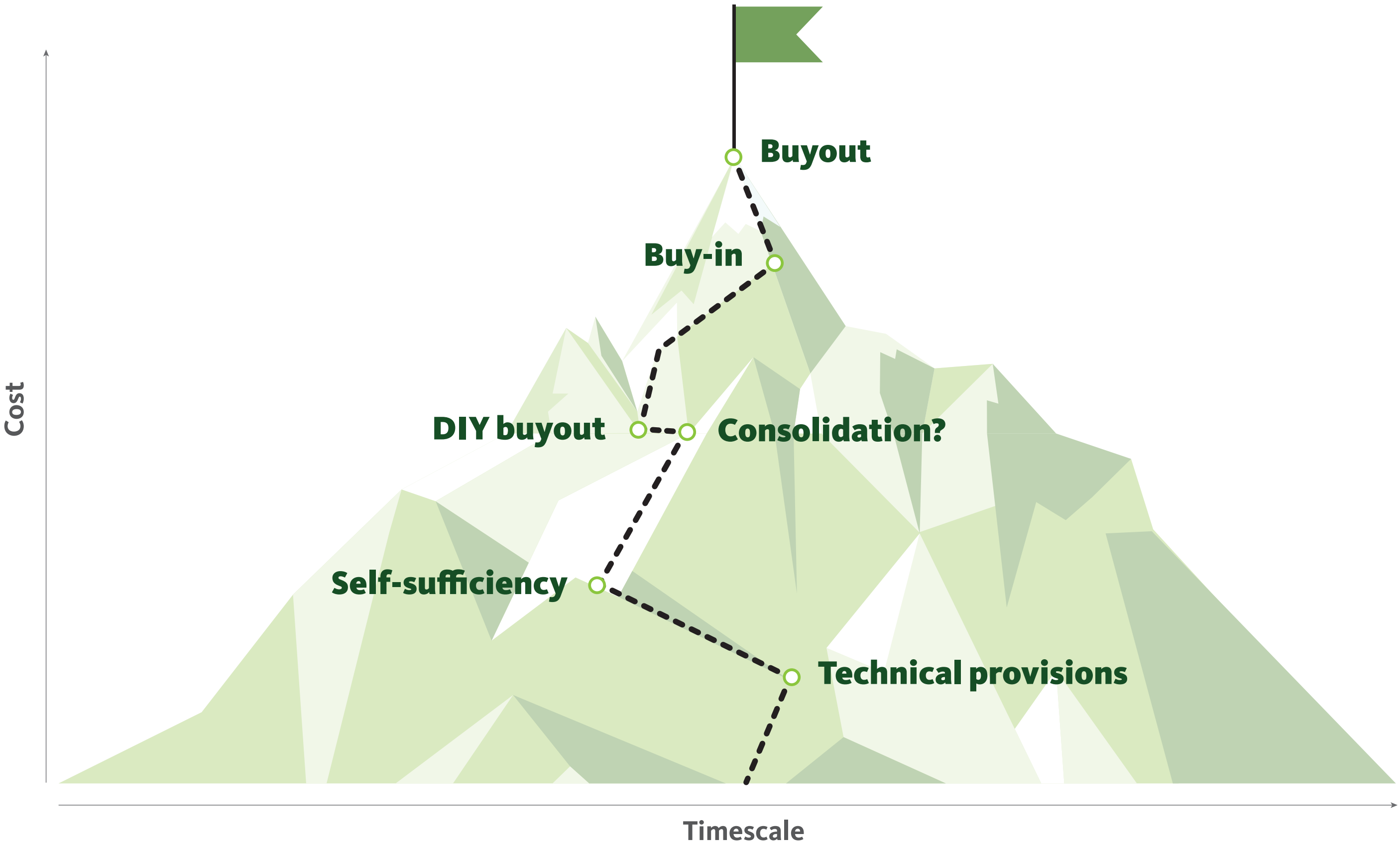
What's your journey's end?
How do you get there?



Source: For illustrative purposes only.

Mapping your route **to End Game**

There are many factors for trustees to consider when discussing which end game is right for them, including:

- Member security
- Cost to the employer
- Covenant strength
- The return required from the remaining assets to get to full funding
- Whether the remaining liabilities can still be matched with the remaining assets

Whichever end game solution trustees select will impact these components differently, meaning each scheme must make decisions about how and where to compromise. Weighing up the advantages and disadvantages of each scenario is crucial to making an informed choice.

Self-sufficiency – **together till the end**

What is it?

When schemes target self-sufficiency, the trustees and employer agree to support the defined benefit pensions of their employees (past and present) until they are all paid. In doing so, there lies a reasonable expectation that the scheme will not need to call on the sponsor again for additional funding. This often results in a lower cost solution for the company in terms of contributions required, whilst the trustee board is able to oversee the payment of the pension promises made to their former employees in a paternalistic fashion.

SEI client case study

Self-sufficiency is the option that a large engineering client opted for. One of their defined benefit pension schemes was relatively small in comparison to the size of their company, and it had been offered to its staff over many decades. Like many companies, the sponsor had a strong stable covenant, and was confident that it could continue to afford to support the pension scheme over the medium and long term. This was especially the case as the scheme was well funded, having benefited from strong investment performance in the past. This allowed for a heavily de-risked investment strategy that sought to protect the healthy funding position.

The scheme had been closed to new members although it was still open to the accrual of new pension benefits. Given that the closure was quite recent, the scheme's membership was predominantly made up of deferred ex-employees and active current workers who were still accruing their pensions.

Outcome

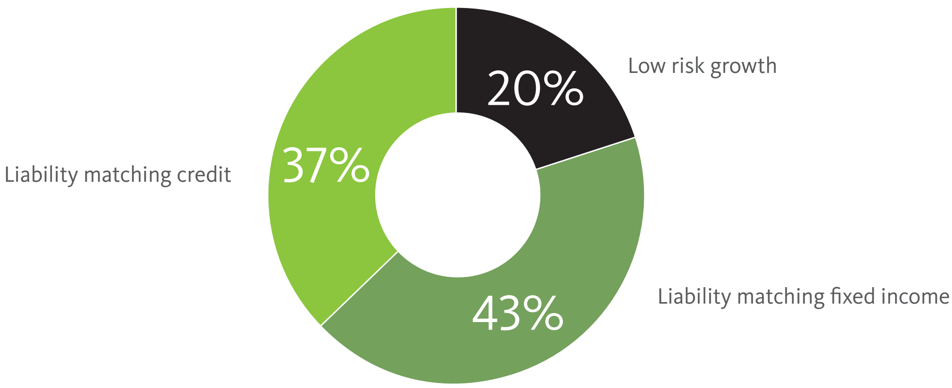
The cost of transferring this type of scheme (with relatively young members) to an insurer through a buyout arrangement was significantly more expensive than continuing to run the scheme on a self-sufficient basis. If the scheme were to target buyout, the liabilities to be funded would have been at least c.20% higher or in this case c.£60m larger.

Given the strong sponsor support and high level of security that the company could provide to its members, the trustees agreed that the scheme target should be run on a self-sufficient basis. This meant that the capital injection required to transfer the scheme to an insurer could instead be put to more productive use if reinvested back into the business.

Reinvestment would grow, strengthen and stabilise the company's position, in turn further supporting the pension scheme. Meanwhile, the scheme's investment strategy could be de-risked to the extent that there was little risk of a significant deficit recurring. A sufficient moderate return could be generated over the long term, which enabled assets to keep steady pace with the liabilities. The trustees would retain oversight of the staff that had been employed over the years, which reaffirmed the scheme's target to deliver pension promises as they fell due.

The graph below demonstrates the stable funding position and investment strategy of a pension scheme managing to self-sufficiency:

Source: SEI as at 30 September 2018.



Source: SEI. For illustration only.

In brief: Self-sufficiency

- Was 20% more cost effective than an insurer buyout
- Allowed for reinvestment into the business to stabilise the company position
- Further support could now be offered to the pension scheme by:
  - De-risking to a position of very low risk of deficit occurring
  - Generating moderate return over the long term
  - Allowing trustees to retain oversight of the employees and maintain pension promises

DIY buy-in – **avoiding a dead end**

What is it?

A do-it-yourself buy-in takes the position of principally holding income-generating, low-risk assets and longevity hedging in order to meet the pension scheme's commitments. Bypassing the need to pay an insurance premium, this approach looks to achieve similar outcomes to a buy-in whilst using fewer assets. Cost saving is an obvious benefit, but is taken in hand with a small risk of additional funding requirements should the experience underperform against the careful assumptions made.

SEI client case study

A large global distribution company's UK entity had a significant defined benefit pension scheme position on its balance sheet. Positive incremental investment returns combined with sizable recovery contributions had helped correct much of the scheme's deficit over a number of years. As the funding level improved to 92% on a self-sufficient basis, the investment strategy was de-risked as laid out in the scheme's pre-agreed journey plan. Liability matching investments were implemented as the market's interest rate and inflation expectations changed. However, longevity risk remained, and it was becoming a larger proportion of the scheme's overall risk in the midst of a de-risking strategy.

The trustees investigated a buy-in arrangement with an insurer that looked to match the risk of pensioners living longer than expected.

For them, this presented a number of issues:

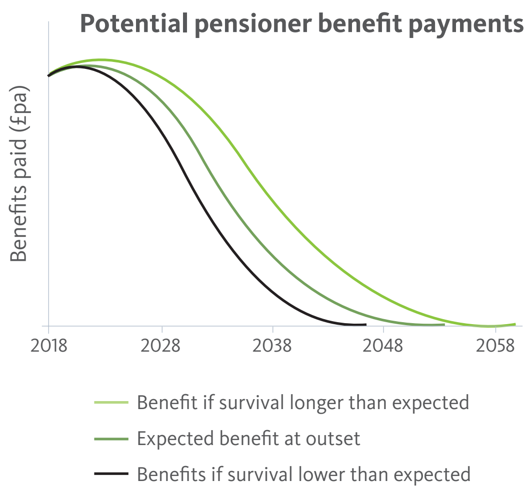
- Whilst the security of delivering benefits to the pensioners would improve, the risk of funding the scheme would be spread across the remaining non-pensioners as a result
- Matching assets in the form of gilts would need to be transferred to an insurer to fund the buy-in. This would leave the scheme with significantly less assets to match the remaining non-pensioners
- The non-pension members were younger in age and their pension benefits were longer dated; consequently their liabilities were more sensitive to changes in interest rate and inflation expectations. In short, more liability matching assets would need to be held to match the members who hadn't retired yet
- Growth assets would need to be reallocated to the matching portfolio to match the non-pensioners. The expected return of the overall investment strategy would then be reduced
- Even for a scheme in a strong funding position, the deficit recovery plan would be put at risk. This would potentially mean the sponsor having to make additional contributions
- The buy-in was a one way transaction, meaning a loss of flexibility should the trustees want to reallocate to growth assets in the future.

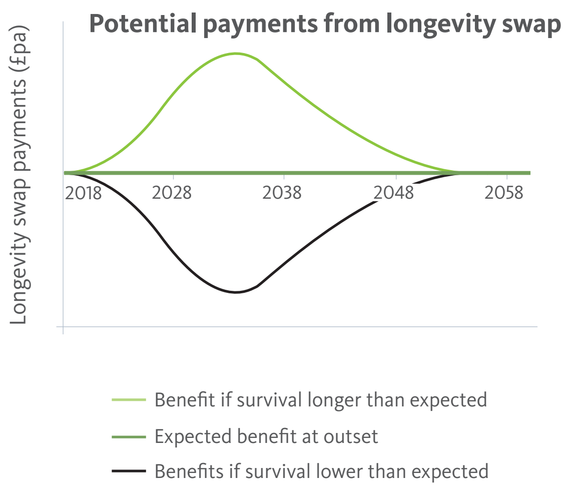
Outcome

Given these concerns, the trustees understandably wanted to investigate more flexible ways to address longevity risk. We recognised that the interest rate and inflation risks of the liabilities could easily be addressed with liability matching investments. Furthermore, credit investments could provide a matching and return enhancing function by generating an extra yield in excess of the liabilities over the long term.

For the remaining longevity risk, a longevity swap could be entered into with a large global reinsurer. If the actual scheme members lived longer than expected, the reinsurer would post assets to the scheme to match their increasing liabilities. Likewise, if pensioner mortality was heavier than expected, assets would be posted from the scheme to the reinsurer, reflecting the fall in liabilities.

The assets could be managed so self-sufficiently that in effect a 'do-it-yourself' buy-in could be built.





Source: SEI. For illustrative purposes only.

In brief: DIY buy-in

- Longevity risk was matched as with a buy-in, whilst the scheme's trustees retained control of the underlying assets
- The investment strategy did not have to be changed to differentiate between matching pensioners and non-pensioners
- No subsequent side-effects whereby reallocations had to be made between growth and matching assets
- Significant cost saving; transacting directly with the reinsurer removed the incursion of additional premiums

For SEI, this solution was easily scalable, making it available for all clients should they choose.

BUY-in –
Try before you buyout

What is it?

In this solution trustees purchase an insurance policy to cover the liabilities of a group of their members, for example, current pensioners in payment. It is considered a 'match' to the covered liabilities, with the trustees holding the insurance policy as an asset whilst retaining responsibility for paying the pensions. This is in contrast to a buyout, where the liabilities of the entire scheme are transferred to the insurer.

SEI client case study

A company with a long presence in the UK mining sector supported a defined benefit pension scheme with a significant proportion of retired pensioners. The pension scheme had a strong funding position that had already benefited from matching most of its assets to its liabilities. This matching strategy coupled with steady low volatility growth investments had gradually improved the funding level over time, resulting in a large amount of physical bonds backing much of the liabilities, as the scheme investments had been de-risked.

It became apparent from insurance pricing that a buy-in asset could be sought to match some of the pensioners at a price that was cheaper than the scheme had reserved for. Although the longevity risk associated with some of the elder pensioners was not that high—especially compared to the scheme's younger members who hadn't yet retired—the trustees thought that it would nevertheless be helpful to insure this longevity risk.

Before undertaking a buy-in, it is essential that the fiduciary manager carries out essential checks. SEI investigated whether there would still be sufficient assets left to match remaining non-pensioners in the event of transferring the pensioner matching assets to an insurer.

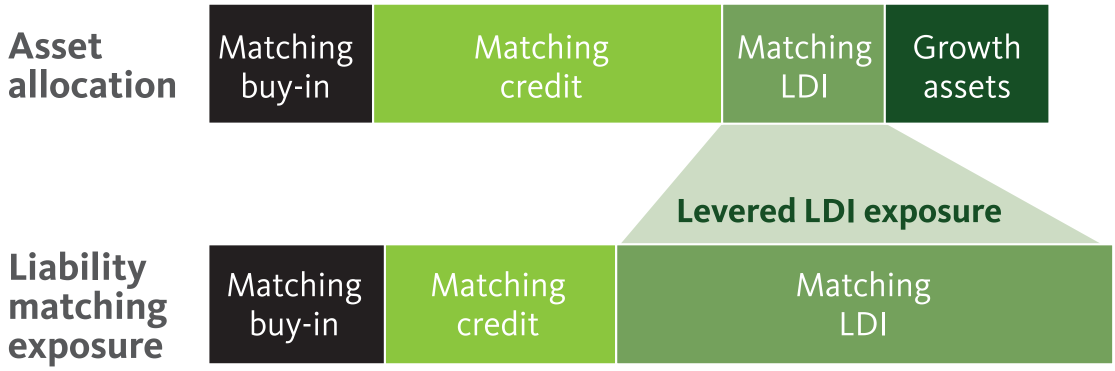
Given that this scheme was so well funded, it was in the rare position of being able to transfer physical matching assets to an insurer and still have enough reserve assets to match the remaining liabilities.

The scheme would be locking up assets over the future life of the pensioners by investing in the buy-in, and for the non-pensioner liabilities, sensitivity to changes in interest rate and inflation expectations remained. In order to match these factors, a greater number of derivatives were required and the scheme still needed all of its growth assets to generate the returns to meet its liabilities.

Outcome

The trustees satisfied themselves that the derivatives exposures in the liability matching assets would become more levered. They were also comfortable that more assets would need to be paid away to match any future decrease in value of the liabilities.

Entering into a buy-in can mean that liability matching assets become increasingly levered:



Source: SEI. For illustration only.

As a result of this approach, there was a moderate increase in the scheme's ongoing funding level, given that the buy-in was slightly more economical than originally forecast. The insurer also offered the pensioners a level of security that was similar to or potentially better than that presented by the strong backing sponsor.

Nevertheless, these advantages were counterbalanced with some disadvantages:

- If the scheme wished to pursue a full buyout at a later date it may be tied to the provider of the buy-in
  - It is common for buy-in providers to stipulate periods of no competition when it comes to subsequent pricing of full buyout or further buy-ins
- The scheme had been left with the more irregular pension benefits. The easier benefits to match had been taken on by the insurer.
  - This made the remaining liabilities harder to insure and full buyout at a later date potentially harder to transact.

In brief: Buy-in

- Derivative exposures were increased to match asset sensitivities for remaining non-pensioner liabilities
- The scheme's funding level experienced a moderate increase due to the cost savings of the buy in against forecast
- The buy-in retained security for the pensioners, in line with that offered by the sponsor

However:

- The scheme is potentially negatively tied to the provider of the buy-in
- The scheme has been left with the more irregular pension benefits, making full buyout at a later date potentially harder to transact

Buyout – end of the line, **all change please**

What is it?

A buyout transfers the responsibility for meeting pension scheme member's liabilities to an insurer in their entirety, removing the risk from the sponsoring employer. The trustees pay a premium for this solution, effectively 'winding up' the pension scheme. Once a buyout is complete, the member is issued with a contract from the insurance company directly, severing all ties with the former sponsor and trustees.

SEI client case study

Where sponsor covenant is a concern, transferring all of a scheme's assets and liabilities to an insurer can provide members with more security should the sponsor get into financial difficulty. Of course, the cost of this full insurance cover is often the most expensive end game solution.
Full buyout liabilities can be in the region of 20% to 30% higher than those calculated on an ongoing Technical Provisions basis.

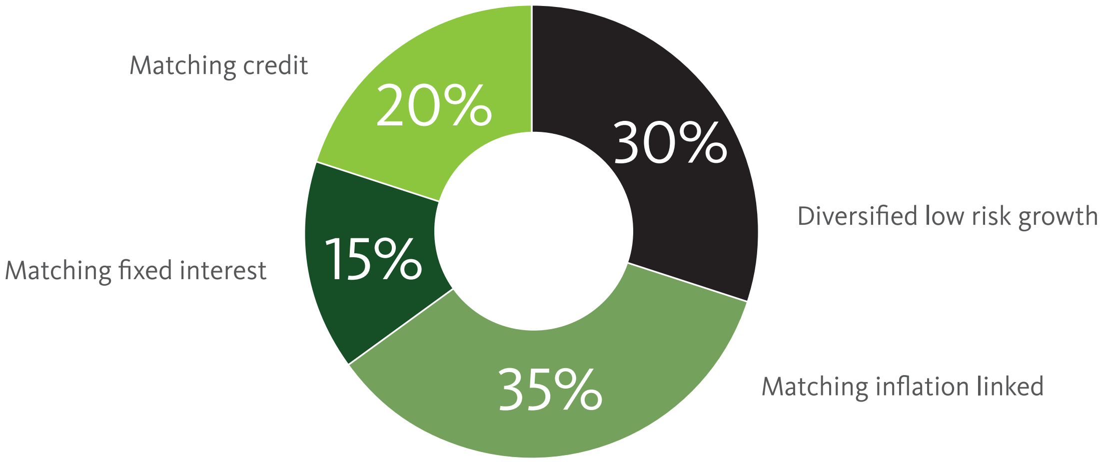
Reaching this requirement will therefore usually result in significantly greater contributions from the sponsor, as well as a new investment strategy. However, if these caveats are affordable, it can be a sensible option for certain schemes. This was the case for one of our well known high street clients who—like many other retail names in recent years—became financially challenged, ultimately to the point of liquidation.

As news emerged of the company's precarious position, financial details were shared with the trustees. It was known for some time that the company did not have the strongest of covenants. The open and transparent dialogue between the trustees and sponsor had previously allowed the pension scheme to target a prudent funding position. This joined up communicative approach gave the trustees, Fiduciary Manager and Scheme Actuary as much time as possible to act when it became apparent that the company was in a severe financial situation.

Outcome

The agility that a fiduciary solution allows meant that the scheme's investment strategy was de-risked swiftly and efficiently. This immediate de-risking enabled buyout pricing to be matched, securing valuable benefits for all the scheme's members despite market volatility. Had the scheme fallen into the Pension Protection Fund, this would not have been the case.

A low risk portfolio to help match buyout pricing



Source: SEI. For illustration only.

A best-in-class transaction process

In order to facilitate optimal outcomes for scheme members, SEI partnered with an independent transaction adviser during this process. Their incentive was straightforward and nonconflicted; execute the insurance deal that delivered security to and met the best interests of the scheme's pensioners, past and present. Given that their advice was not bundled or allied with the management of the scheme's assets or the provision of actuarial tasks, this relationship proved to be highly effective.

In brief: Buyout

- SEI was able to de-risk as soon as financial distress came to light, owing to the agility afforded by joined up investment advice and management
- Buyout pricing was matched while the scheme was in the PPF's assessment period
- The matching of buyout pricing allowed the transaction adviser to take the time to find the insurance deal that best worked for the scheme
- It gave the PPF the time to assess if it could accept the scheme
- It enabled a buyout to be secured with benefits greater than those of the PPF, at a favourable price

Consolidation – **a means to an end?**

What is it?

The UK government's Department for Work and Pensions has stated its ambition to support and consult on another route to an end game that facilitates pension scheme consolidation*. Consolidation here means more than just bundling actuarial, administration and investment or fiduciary management services as it stands today.

The potential game changer lies in the severed link between scheme and sponsor; the scheme is in effect transplanted to a new sponsor, who supports it financially going forward. Put simply, the scheme is fundamentally separated from its creator and no longer appears on its balance sheet.

It is yet to be seen how this potential end game—with a regulation back-stop—will develop. It could be a viable solution if a pension scheme is willing to pay a premium to boost its funding level and fund a consolidator's reserving and profit requirements. For some, improving the funding position enough to enable a buyout may be out of reach, but improving it enough to transfer it to a consolidator may be possible.

This route could well be attractive to a company that would like to permanently sever financial support to its DB pension scheme and rid itself of the associated balance sheet risk. Of course, pension scheme trustees would need to fully investigate a consolidator's sponsor strength before switching financial support to another entity. To reach this potential end game, an investment strategy would need customising to a target that meets the consolidator's funding requirements over a suitable time horizon, with a suitable level of risk.

In brief: Consolidation

- In the new world, consolidation severs the link between scheme and existing sponsor, eradicating the scheme from the balance sheet and transferring it to a new sponsor
- Close inspection of sponsor strength from trustees will be vital
- Development is in its early stages but consolidation in this form could be a viable solution for schemes, or where buyout is out of reach but the funding position can meet the consolidator's requirements
- The investment strategy would require customisation to the consolidators funding requirement

*https://www.gov.uk/government/consultations/defined-benefit-pension-scheme-consolidation

All things come to a good end?

As we have explored, there is a wide range of end games available to pension schemes, including self-sufficiency, 'do-it-yourself' buy-ins, insured buy-ins, buyouts, or even a potential new destination in consolidation.

Our heritage has taught us that each scheme needs to carefully consider what is important to them. There are many components to evaluate in this process, from sponsor covenant strength, budget and member security to the ability to match remaining liabilities, the ability to target the same return in recovery plans and the level of paternalism with which trustees would like to deliver their pensions.

Only when a scheme has identified its key priorities and concessions is it in a position to target an end game that is right for them. Once defined, this allows for investment advice that is further refined to the scheme's goals that can be implemented efficiently through a manager of managers platform.

Ultimately, our goal as a fiduciary manager is to help improve the funding levels of our clients in order to put end game conversations on the table.

Our next objective is to put a successful overarching strategy in place for any end game solution, and make sure that it remains appropriate. Having guided clients through a number of end game scenarios, we are confident that we are able to cater to for the unique needs of each scheme and guide them to their ultimate goal.

When end game is in view, SEI's specialist partner transaction advisers are engaged to secure an insurance deal that is best aligned with a scheme's needs. In this process, free from conflict, clients are reassured that the only objective in mind is securing the best benefits for pension members.

> **What is clear is that at each stage of a scheme's journey, from navigating volatility to the final destination, a specialist with experience in the range of available end game solutions is best placed to target and deliver the end game that is in the scheme's best interests.**

SEI can help clients navigate the full suite of end game solutions. Speak to an expert to find out more.

0203 810 7604 Institutionsuk@seic.com seic.com/institutionaluk

Looking to reach your end goal?

Find out more about how we can navigate you to your final destination.

Speak to an expert:
0203 810 7604

institutionsuk@seic.com
seic.com/institutionaluk

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