



The benefits of BrightonRock to Sponsors

Summary

The BrightonRock insurance policy brings many benefits to sponsors of defined benefit pension schemes. It:

- Solves a demonstrable problem faced by sponsor and trustees at an affordable price
- Allows sponsors to address the question of optimal financing of their scheme from their current position
- **Capitalises the value of the sponsor covenant to the pension scheme, without incurring any sunk costs.**
- **Reduces the total cost of financing pensions without jeopardising member security, by allowing sponsors to:**
 - target full-funding, not excessive over-funding
 - lower contributions, but retain scheme funding flexibility
 - reduce balance sheet volatility
 - deploy capital in business, rather than having it locked in scheme
- Reduces management burden and confrontation with trustees: allows trustees to do their job and sponsors to do theirs
- **Encourages scheme flexibility while maintaining member security**
 - Lowers regulatory compliance costs, interventions and surprises
 - Allows scheme to remain open and facilitates the optimal design of benefits offered
 - Removes short-term and transient funding concerns
 - Permits investment flexibility
 - Is robust to corporate transactions – facilitates M&A
 - **Any or all of which may be earnings accretive**
- Reduces scheme termination costs, bulk annuity, when that is desirable.

Background

The ethos of BrightonRock is one of security and continuity. The BrightonRock contract says “*upon sponsor failure BrightonRock will pay pensions in full*”. This is achieved by BrightonRock providing on sponsor insolvency, in exchange for the scheme assets, individual annuities to each member for the full amount of their accrued pension according to the scheme rules. While both the sponsor and insured scheme exist an



annual premium is paid for the insurance¹. Once on risk there is no circumstance in which BrightonRock can cease to provide cover. In contrast, the sponsor/trustees can exit at any time².

The benefits of such cover are self-evident to pension scheme trustees as it directly addresses the “sponsor covenant”, the key risk of concern to them³. However, at first sight the reasons why a company would wish to insure against its own insolvency are obscure⁴. The answer lies in the **overall cost-effectiveness** of how the defined benefit pension scheme, willingly established by the sponsor, is financed.

The optimal financing strategy in turn depends upon the incentives and risk-sharing among sponsor and employees, within a regulatory framework designed by government overwhelmingly with pensioner protection in mind. This should not be surprising as the dominant perceived risk within government is increased pensioner reliance upon the state system if schemes should fail. The result is a system of regulations where risk and cost is increasingly borne by the individual scheme sponsor. There is scant regard in this system of regulation for the consequences to sponsors, or the economy more generally of such risk and cost burdens. The obvious solution lies with private sector indemnity assurance for these risks. In summary BrightonRock allows risks currently borne by each sponsor individually to be pooled, and results in **demonstrable cost savings** to the sponsor, individually and collectively.

The Problem

It was not that long ago that a defined benefit pension scheme was a friend of the sponsor. The actuary said that no contributions were needed from the company. The accountants showed the pension scheme was a source of profit to P&L. And the scheme surplus financed the voluntary early retirements that smoothed business restructuring. Much has changed. While the halcyon days are unlikely to return in full, BrightonRock can help to reinstate the pension scheme as a desirable feature to the sponsor.

¹ The contract is tripartite: BrightonRock, sponsor, trustees. By virtue of its term, this is technically better described as indemnity assurance rather than insurance.

² This is achieved by extinguishing the insured liabilities, for example by bulk annuitisation or GN16 transfer to a new scheme. The asymmetry between BrightonRock and customer will ensure that BrightonRock is managed to the highest standards; it is exposure to market discipline.

³ The benefits for trustees are demonstrable and manifold, and explored at length in “The benefits of BrightonRock to Trustees”.

⁴ Recognising that pensions are deferred pay makes it more obvious. It is the element of deferral which creates dependency between trustees (representing members) and sponsor. The parallel is with individuals purchasing whole of life assurance to protect their dependants.



Today the pension scheme has become anything but a friend. It became fashionable amongst commentators to talk of the “perfect storm” that hit pensions: low interest rates, volatile equity markets and an upwards reassessment of member longevity. Company cash contributions have sky-rocketed. The revised accounting standard has brought market volatility directly onto the sponsor’s balance sheet. New legislation⁵ has created the Pensions Regulator, the Pension Protection Fund (PPF) and Scheme Specific Funding. The powers of the scheme trustees have increased and the sponsor has been distanced - the amount of management time spent on pensions has increased dramatically. There is a new levy which finances the PPF’s compensation, a burden on sponsors which is unpredictable and unstable year-on-year, and rising rapidly. Contributions to the PPF are entirely sunk costs for scheme and sponsor. The pressures are to over-fund the pension scheme and invest more cautiously with fixed income instead of equity – drags on sponsor cash-flow and profit. And pension matters are impeding, if not preventing entirely, corporate activity such as mergers and acquisitions.

Even termination of the scheme has become more difficult and costly. New regulation has produced a barrier to exit as termination of a scheme may now only be effectively achieved by bulk annuity purchase from a regulated life insurance company. This requires the payment of substantial costs in excess of the fair value of pension liabilities, typically of the order of 25 percent of their value. Recent additions to the legislation are concerned with the enforcement of this barrier.

The “pension crisis” has hardly been out of newspaper headlines over recent years. Perhaps to a journalist any problem is a crisis; however sponsorship of defined benefit pension schemes has hit companies hard. Real contribution costs have risen eight-fold in just 15 years. A typical reaction from finance directors became: “as I start every day, there, at the top of my in-tray, is the pension scheme demanding my attention”. With pension contribution costs as important as they now are to corporate finances, this is perhaps appropriate, but much of this attention is pure distraction due to the new regulations. And this also shows up in the statistics that are available.

Diagram 1 shows the ratio of pension scheme administration expense as a proportion of pension payments for the period from 1992. It is evident from this that the costs of administering schemes have increased markedly, from approximately 3.5 percent in the early 1990s to approximately 6.5 percent recently⁶. There is evidence that this shift is secular and implies that the new regulatory regimes have very significant ongoing

⁵ Pensions Act 2004

⁶ Absent any changes, the expectation would have been for this ratio to decline slowly.

compliance expenses. This is a staggering increase in administrative costs. It is an increase that is a reflection of the company's management time that now has to be spent dealing with pension matters and determining the strategy that works for both company and trustees.

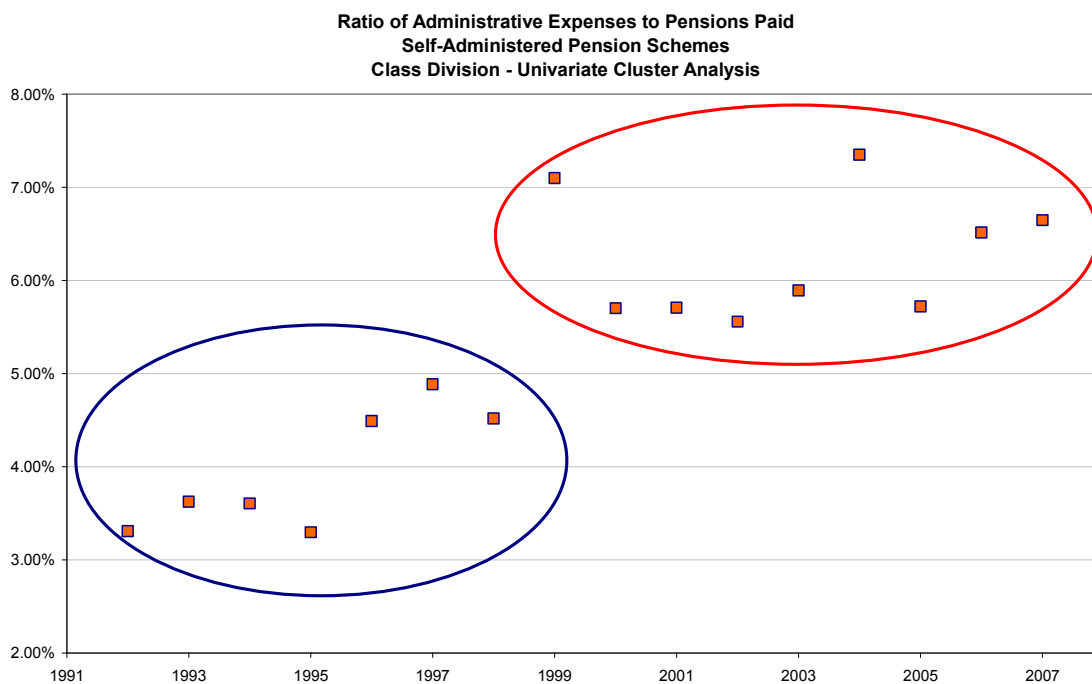


Diagram 1: Source: ONS MQ5 and BrightonRock calculations.

The Solution

BrightonRock overview

The BrightonRock assurance provides mitigation to all of the problems described above. A scheme assured by BrightonRock allows the sponsor to target **full-funding** and not the excessive over-funding we have today. **Corporate cash can - should - remain in the business and not be locked away in the scheme.** By diversifying the pension scheme financing from cash alone to cash plus insurance it lowers the funding commitment⁷, both ongoing and in times of M&A. In assuring the scheme against the

⁷ But without jeopardising the security of members' benefits – in fact BrightonRock will enhance security. The apparent paradox results from the paradigm that was until recently ubiquitous, namely that security equals cash. The paradigm - clearly false - is already challenged with the acceptance of



risks borne by the sponsor, the sponsor is capitalising its covenant and lowering the funding requirement of the scheme by at least this amount. By design the BrightonRock **premium is inherently predictable and stable**, and it displaces the PPF's risk-based levy. The BrightonRock contract places no restriction on scheme investment policy and removes restrictions that exist with the status quo⁸. Scheme investments can re-risk, boosting return so lowering contributions (even after allowance for BrightonRock premium) and increases sponsor P&L. The BrightonRock contract is an asset of the scheme (so no "wasted" sunk cost of the PPF levy) which has positive value at day one⁹. Moreover, it is an asset with desirable contra-cyclical behaviour which reduces sponsor balance sheet volatility – further inducement for **re-risking the investment strategy**.

Trustees will naturally be concerned with the current creditworthiness of the scheme sponsor and potential future deterioration, for which excess funding demands are the sole risk mitigant available to them. This strains relations between sponsor management and trustees, and also distracts trustees from the task of managing the scheme well. BrightonRock removes this concern for all time, hence **fostering ongoing improved relations between sponsor and trustees**.

BrightonRock brings the assurance that scheme benefits will be paid in full in all circumstances¹⁰. Full cover is also directly personally attractive to the management of a sponsor: the PPF maximum benefit is 90%, and can be considerably less for those, typically senior management, with large accrued benefits, particularly on early retirement.

contingent assets by the Pensions Regulator and the Pension Protection Fund. BrightonRock extends security to encompass insurance and represents the next (and final) evolution of a new paradigm.

⁸ BrightonRock removes one of the masters that scheme assets have to serve under the status quo, namely providing security against sponsor failure. The trustees of schemes insured with BrightonRock should perhaps even take direction from the sponsor on the long-term investment strategy that is appropriate for the sponsor.

⁹ And hence an asset of the sponsor too, which appears on the sponsor's balance sheet through the operation of FRS17 (UK) or IAS19 (IFRS) accounting.

¹⁰ The primary cover relates to sponsor failure; however, the BrightonRock policy has been designed so that once a policy is in force the cover cannot lapse in any circumstance as long as the insured pension scheme exists.



Pricing

The premium to be charged by BrightonRock is set by reference to the marginal contribution of the sponsor and scheme to BrightonRock's overall book of business in force. This involves analysis of sponsor financial statements and business plans, together with scheme accounts and actuarial valuations, jointly. This contrasts with PPF levy setting, with its explicit cross-subsidies for the weakest schemes, achieved by charging other schemes higher levies, and emphasis on scheme funding. BrightonRock pricing will reflect the benefits of pooling and structural risk-sharing among sponsors, schemes and BrightonRock, giving the policy initial and ongoing value as an asset of the scheme.

The target market of BrightonRock consists of schemes whose **sponsors will benefit economically** from the introduction of assurance of the BrightonRock design and cost.

Permanency

An aspect of BrightonRock which provokes discussion is that the **premium rate is fixed** at inception for the life of the scheme¹¹. The fixed rate nature of the BrightonRock contract is a key selling point to trustees¹². The cash amount of the premium will change each year, as the fixed premium rate is applied each year to the changing gross measure of the liabilities (Projected Benefit Obligation)¹³. With a fixed premium rate the cost of the cover is inherently stable and predictable year-on-year, which cannot be said or expected for the PPF levy. The improvement for the company's cash-flow management is clear.

It is from the long term stable nature of the BrightonRock policy, that many of the further benefits to scheme sponsors arise. In addition to being a qualifying contingent asset for the purpose of reducing PPF levy costs, **it is an asset of the scheme with transparent value from inception**. It is not a levy payable to a compensation scheme to bail out others, with no value to the scheme sponsor.

BrightonRock places no restriction and in fact removes constraints on the investment policy of the pension scheme. One strategy which sponsor and trustees may wish to

¹¹ The capability to perform such underwriting with confidence is the technical foundation of the BrightonRock business.

¹² The enduring nature of the BrightonRock contract and the permanency of the premium rate give trustees comfort that the cover will not become unaffordable or unavailable just when it is needed most.

¹³ It makes no difference to BrightonRock whether sponsor or scheme pays.



consider is to move to a funded asset allocation which is potentially more volatile but holds the prospect of earning the BrightonRock premium or more. **The policy can effectively be self-financing.**

Contra-cyclical asset

The BrightonRock contract has been designed so that its value as an asset can be determined by applying the accounting standards for financial securities (IAS39). Through the lens of accounting for the customer the BrightonRock contract is a derivative, one whose fair value is determined on a market consistent fair value basis.

Moreover the BrightonRock contract will have a **positive value at inception** to the customer. This is unusual, most derivatives have zero value at inception by design, and insurances usually have negative value to the customer at inception (the insurer expects to make a profit).

The reasons why the BrightonRock contract has positive value at inception can become rather technical and involved. The IAS39 accounting values the contract as the “present value of payout” less “present value of premiums payable”. Given the enduring nature of the BrightonRock cover the present value is taken over all future years. In determining the premium BrightonRock makes allowance for expected recoveries (in addition to expected payout), an aspect that does not appear in the IAS39 equation. So the present value of premium will be less than the present value of payout, giving a positive value to the customer.

At inception of cover the value of the BrightonRock contract to the pension scheme would typically lie in the range 3% - 15% of liabilities if the premium is paid by the sponsor. This is the extent to which funding of scheme liabilities is no longer necessary; the primary source of cost saving to the sponsor employer. If the premium is paid by the scheme this falls to a net 0.5% - 5.5%, since the scheme must then account for the liability to pay future premiums.

In both cases the scheme asset appears on the sponsor balance sheet through the operation of pension accounting standards. In the former case where the premium is paid by the sponsor there would be a corresponding liability (together with deferred tax credit) on the sponsor balance sheet in respect of the present value of future premiums. The net effect to the sponsor, a gain, is the same regardless of whether the sponsor or the scheme pays the premium.



The BrightonRock contract is an asset with further desirable characteristics – **its fair value is contra-cyclical**. As the sponsor creditworthiness declines, the BrightonRock asset value increases. As the scheme funded status worsens, the BrightonRock asset value increases. It is not a perfect hedge, nor is it designed to be. But it is definitely contra-cyclical and acts to remove up to one-third of the volatility that arises under FRS17/IAS19 with the mark-to-market valuation of the scheme assets and liabilities. Therefore the pension scheme valuation is less volatile, and the corresponding accounting item on the sponsor balance sheet is less volatile.

The BrightonRock policy contains a clause which credits all premiums received to reduction of the cost quotation of any elective bulk annuitisation of a scheme, including partial. Premiums paid are therefore not sunk costs. This sets a minimum and increasing value to the BrightonRock policy as an asset of the scheme.

Service Costs and Special Contributions

BrightonRock will make **no demands for special contributions**. Its sole condition is that new liabilities only be admitted to the scheme for contributions received, and recognises that a scheme may be sufficiently well-funded that no cash contribution is required. The sponsor should expect to contribute to the scheme only the current service cost.

A sponsor finance director may wish to view the BrightonRock policy from the accounting perspective. Here the balance liability for future premiums payable to BrightonRock is seen as the unfunded financing which supports the pension scheme asset which takes it to the level of full buy-out and is of course very long term.

The BrightonRock policy will lower premiums to a nominal sum for any scheme which is funded at the level of 115% or higher, since at these levels of funding the scheme represents no material risk to BrightonRock. Schemes funded at these levels are encouraged to take contribution “holidays”.

Cost Effectiveness

The PPF levy is composed of two components: the scheme based levy and the risk based levy, with regulation specifying that 80% or more should be risk based. BrightonRock will qualify as a PPF Type C(i) contingent asset, the effect of which is that the **risk based levy will fall to zero**.



BrightonRock is also working with government to reduce or remove many other redundant cost aspects of insured scheme regulation, such as the scheme based levy and recurrent S179 valuations.

In most circumstances the BrightonRock premium will initially be greater than the PPF levy. This is to be expected as the level of risk cover is considerably greater¹⁴.

There is though considerable doubt as to the future costs of the PPF levy. One indication of this ultimate cost may be derived from the PPF requirement that a level of scheme funding of 140% is necessary for the risk based levy to fall to zero. A 40% premium over full funding is equivalent to a 2% annual charge - 4 to 20 times greater than BrightonRock.

The government hope that the levy will stabilise is not well founded - the levy is inherently unstable as it is linked to scheme deficits and based upon a mutual structure with a declining heterogenous population. This instability adds to the PPF's costs and inherent inefficiency.

Corporate transactions

The inefficiency of the PPF is rooted in its institutional design. It is a compensation scheme attempting to resolve a problem of corporate and pension risk management, for which an insurance company is superior. The risk of pensions is technically the product of the likelihood of sponsor insolvency and the magnitude of any scheme deficit. As government sponsored enterprises, it and the Pensions Regulator are poorly suited to intervene in private sector corporate affairs. The result is that it must use the tools available to it, the amount of the levy and the level of scheme funding, to reduce the consequence of an insolvency event – the result is an inefficient and very costly, incomplete and inadequate solution.

BrightonRock brings security and continuity to the operation of a defined benefit pension scheme, but also shares common incentives and interests with the corporate sponsor in times of distress. In this regard, it is unique. A creditor has already

¹⁴ The PPF by its own admission only covers about one-fifth of the sponsor covenant risk - stated by Martin Clarke, Executive Director of Financial Risk at the PPF, at a Faculty of Actuaries Sessional Meeting, 18 February 2008, Glasgow. A back of the envelope derivation is that PPF benefits can be provided by the private sector bulk annuity insurers at 105% FRS17 and full benefits at 125% FRS17. So a fully funded scheme (i.e. 100% FRS17) has a 25% sponsor covenant exposure, which the PPF covers the first 5%.



committed funds and is primarily interested in recovery – this is a position shared by the PPF. BrightonRock, in this time of distress, has not committed funds but knows that losses under its policy may be imminent – it has the choice of advancing funds to avoid insolvency and the losses under its assurance policy, or simply of allowing developments to occur and then meeting the policy commitments of paying all pensions in full. BrightonRock’s management policy, following the London Approach, will be to seek to maintain the enterprise and employment where practical. **The interests of sponsor and BrightonRock are well aligned in these difficult times.**

Moreover, BrightonRock brings security through the other significant time of change: corporate transactions such as mergers as acquisitions:

- For a vendor with a scheme already insured with BrightonRock, a business disposal creates no difficulty. If pension liability is transferred as part of the sale then the remaining liability insured with BrightonRock has decreased, and so will the premium at the next anniversary. Similarly, bringing a new business and associated pension scheme into a group creates no difficulty for BrightonRock. The value of liabilities has increased and so does the premium correspondingly.
- For a purchaser BrightonRock can facilitate a transaction where otherwise the pension scheme would be a showstopper¹⁵. At the time of corporate transaction the spotlight falls on the sponsor covenant and how that may become weakened, a topic that is front of mind with the Pensions Regulator. Trustees demand extra contributions to bolster the funded status - to full buyout level - the quantum of which can break a deal. With BrightonRock the security that the trustees rightly demand can be achieved at lower overall cost through use of insurance, and certainly with a lower immediate cash requirement.

The BrightonRock contract will contain covenants and warranties from both sponsor and trustees – they will be tailored to each company. These exist to protect BrightonRock against moral hazard, to prevent actions by either sponsor or trustees which they otherwise would not have taken if the BrightonRock cover did not exist. The covenants are not designed to impose restrictions on how either sponsor or trustees go about their day-to-day business – to do so would be self defeating.

¹⁵ "Simon Walker, chief executive of the British Private Equity and Venture Capital Association, added that the BVCA was considering recommending that its members avoid buying any companies with defined benefit pension schemes until legislation was published at the end of the year." - Financial Times 17 April 2008, *Plan to allow pensions watchdog to issue fines over schemes in red*



Corporate transactions may breach the BrightonRock covenants. A breach of covenant does not void the cover. Instead in such an event BrightonRock may require the scheme to be wound up and individual annuities provided, the cost of which falls on the sponsor. But this demand is, of course, ultimately unenforceable since the ability of the sponsor to exit the policy by liability discharge through a GN16 transfer remains and is well understood. What this means in practice is that all parties renegotiate the terms of the BrightonRock cover to achieve an outcome that is beneficial to everyone – there is alignment of interest. It is far from clear the equivalent regulatory procedure, Clearance, achieves a similar alignment of interest among the various parties.

Conclusion

The BrightonRock approach to insuring a defined benefit pension scheme brings many benefits to sponsor and trustees. For trustees it directly resolves a key risk, the sponsor covenant, which is the source of much tension between trustees and sponsor. And for sponsors it significantly reduces the burden that well intentioned but perhaps misguided legislation has created. The vagaries of the PPF levy disappear, replaced with a predictable and stable premium. And most importantly, schemes insured with BrightonRock allow the sponsor to target full-funding, not excessive over-funding, and deploy corporate capital in the business rather than locking it away unnecessarily and unproductively in the pension scheme.