



The benefits of BrightonRock to Trustees

1. Trustees will buy the BrightonRock contract because:
 - There is a demonstrable trustee problem which BrightonRock solves
 - The price is affordable to both trustees and sponsor
 - Risks become transparent and therefore manageable by Trustees
 - Cover from a BrightonRock contract offers flexibility, for example in scheme investment
 - The financial strength of BrightonRock will be very high and pension security is assured.

The Problem

2. In theory, the duty of a pension scheme trustee is simple: to pay pensions in full to members¹ when they fall due. In practice, however, fulfilling their duty has become increasingly complex. Trustees must operate in accordance with the Trust Deed and Rules for their scheme, Trust Law generally, and a never-ending and changing volume of pensions legislation².
3. Any discussion of pensions inevitably turns to risk, with longevity (people living longer), equity prices (falling, volatile), and fixed income yields (low) usually at the top of the list. While these risks are real and burdensome on trustees (and the management of the sponsor who ultimately bears the cost), they are operational in nature.
4. The strategic risk in pensions is the failure of the sponsor. **This is because it is only through sponsor insolvency that pensions can be reduced.** If the sponsor is solvent then pensions will be paid in full as per the Trust Deed³. If a sponsor becomes insolvent then the Pension Protection Fund will apply and provide compensation with payout at a maximum 90% level. Moreover, the PPF is legally obliged to cut compensation to lower than 90% if its financial status requires it to do so (that is, although the PPF cannot fail, the compensation it pays can fall far below what a member was promised by the sponsor).

¹ More precisely: pay benefits to beneficiaries.

² The Pensions Act 2004 contained 100 new sets of regulations and provided for up to 12 new codes of practice. The Finance Act 2004 included 40 new sets of regulations and the accompanying Technical Notes alone run to 3,000 pages.

³ Changes made to legislation effective 11 June 2003 simplified matters to that which we have today.

5. The gap between full benefits and the lower amount paid upon sponsor insolvency is referred to as the “sponsor covenant”. It is by far the most important concern of trustees.
6. The only way at present to remove sponsor covenant risk is to fund the pension scheme at a level at all times where full bulk annuity buyout is possible. This typically costs 125% of the liabilities (on FRS17 basis). Of course, if a sponsor is willing to fund a scheme at that level then it will be logical to free up management time spent on the pension scheme by closing it down and transferring the liability to an insurer. But some may consider such action to be “trustee suicide”, because (i) the value for money of a promised benefit is, at those funding levels, very poor and (ii) it is in the interest of trustees for the scheme to stay open to new members, not to close.
7. So the problem is real and a cause of much tension between trustees and sponsor. The problem is a structural one within DB. It has always existed but recently it has become especially pronounced for a number of reasons including:
 - when they were younger, schemes were much smaller relative to the size of their sponsor;
 - legislative changes (for example Limited Price Indexation) have caused the practice of discretionary benefits to cease – it was the potential variation of discretionary benefits that acted as the escape valve on sponsor insolvency;
 - legislative changes known as “preservation”, from the 1970s forward, created the class of “deferred pensioner” which accelerated the growth of the size of pension liabilities;
 - the need for increased transparency due to accounting standards.

Managing risk

8. The PPF by its own admission only covers about one-fifth of the sponsor covenant risk⁴. BrightonRock provides full insurance of the sponsor covenant, and this simplicity and completeness is reason alone for trustees to purchase; the alignment with trustee and member interests is clear and self-evident. For a scheme insured with BrightonRock the trustees know that in all circumstances

⁴ Said 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 at 105% FRS17 and full benefits at 125% FRS17. So a fully funded scheme (ie 100% FRS17) has a 25% sponsor covenant exposure, which the PPF covers the first 5%. Pension scheme trustees have a relationship with the PPF which is rather similar to that of Heather Mills and Mr Justice Bennett (the judge)!

members will receive full pensions⁵ since the strategic risk of sponsor insolvency is covered. As insurance BrightonRock both satisfies tPR guidance, and also benefits as a backstop from membership of the Financial Services Compensation Scheme rather than PPF.

9. The financial strength of BrightonRock will be “very strong” with the insurance volume written restricted to ensure a AAA rated risk profile. Trustees can be reassured that BrightonRock will be run conservatively as the PPF requires that the writer or provider of any financial solution which removes or reduces the amount of risk based levy payable has a formal credit rating of at least AA- or Aa3. An illustration of the BrightonRock conservatism, which is tangible to trustees, is that all premiums will be written direct to reserves.
10. While the BrightonRock contract brings better coverage than the PPF, it also brings better value, which clearly is attractive to both trustees and sponsor⁶. The design of the BrightonRock contract means that it is also an enduring solution⁷. This permanency, both of existence of cover and of price (covered below), is important: all other products in the pensions market which seek to address sponsor covenant risk are limited term in nature and are therefore unsatisfactory to trustees. Moreover, the BrightonRock permanency is robust to M&A activity, which, when it occurs, is a major concern to trustees.
11. A scheme insured with BrightonRock breaks the dependence of benefit coverage on scheme funding at the point of sponsor insolvency⁸ and it is this which brings many additional benefits to trustees and sponsor. For example, the scheme can remain open, with greater investment flexibility for trustees and freedom from scheme over-funding for the sponsor⁹. Thus BrightonRock brings the security and continuity to allow trustees to do their job.
12. An aspect of the BrightonRock contract which invariably provokes discussion is the lack of restriction on scheme investment policy. The scheme’s asset allocation and manager selection is a key activity performed by trustees. Many of the new risk management products impose significant restriction on investment

⁵ Breach of covenant does not cancel the contract.

⁶ One reason for the better value is the stability of the premium relative the PPF levy which is inherently unstable being linked to scheme deficits.

⁷ Once effected BrightonRock cannot walk away from a contract for any reason, although the customer can exit if they so wish.

⁸ This is illustrated in the Dead Zone diagrams that appear in BrightonRock presentations.

⁹ There are others, including the contract is an asset of the scheme with contra-cyclical behaviour to the sponsor’s credit standing and size of scheme deficit.

policy¹⁰. BrightonRock imposes no such restrictions and in fact goes further by removing constraints on investment policy that exist under the *status quo*. One of the reasons why pension scheme investment policy can be problematic is that the assets have to simultaneously serve two masters. First they have to provide the long-term return to pay pensions and second they have to protect against short-term sponsor insolvency. With BrightonRock insurance, the second master is removed, allowing trustees to set investment strategy with proper diversification and true long-term objectives.

The Price

13. Another aspect of BrightonRock which provokes discussion is that the premium rate is fixed at inception for the life of the scheme¹¹. The capability to perform such underwriting with confidence is the technical foundation of the BrightonRock business.

14. The permanency of the premium rate is a key selling point to trustees, giving them the comfort that the cover will not become unaffordable or unavailable just when it is needed most.

15. We expect that with most BrightonRock customers the premium will be paid by the sponsor. Although the scheme assets are legally controlled by the trustees, they are economically assets of the sponsor. This would represent nothing unusual; many schemes already operate with their sponsor meeting the cost of operational expenses such as asset management or benefit administration. Such arrangements give the trustees the ability to pay the premium if the sponsor, for whatever reason, does not¹².

16. The question of affordability is really one for the sponsor rather than the trustees. BrightonRock's target market is those schemes where the sponsor will gain economically from the insurance. It is this principle that drives the underwriting heuristics¹³ which give BrightonRock a possible eligible market of broadly two-thirds of the total market. For target market customers the BrightonRock premium will be between 0.1% and 0.5%. **At this level of premium**

¹⁰ For example, the product provider manages a substantial or all of the scheme assets as part of the risk management solution.

¹¹ 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).

¹² It makes no difference to BrightonRock whether sponsor or scheme pays.

¹³ Maximum sponsor default rate of 1% per annum, scheme size between £30m and £3.5bn and at least 85% FRS17 funded at inception.

BrightonRock will provide a total financing cost of pension benefits in the range 90%-110% FRS17¹⁴. The cost saving relative to a buyout cost of 125% is self-evident and the premium rate is clearly affordable. The consequence of the release from over-funding that BrightonRock enables is an order of magnitude greater than the expected premium. And the insurance obviates the PPF's risk based levy¹⁵ which acts to mitigate the cost of the BrightonRock premium; further mitigation is provided by the fact that the contract is an asset of the scheme.

17. The BrightonRock premium can be thought of as an “asset management” fee applied to the liabilities rather than the assets – it is the same order of magnitude, and for the majority of schemes will be less. It can be self financing: recall that BrightonRock places no restriction and in fact removes constraints on the investment policy. The scheme investments can be re-risked for higher expected return to meet the BrightonRock premium. Paraphrasing what one actuary at a major consultancy said: “an extra 50 basis points on my assets, I can get that easily from changing my investments”.
18. The BrightonRock premium rate will be compared with the market spread on credit default swaps. BrightonRock will be demonstrably cheaper.
19. The fixed premium payable under the BrightonRock contract will decline to a nominal administration fee should a scheme find itself funded at 115% or more of the FRS17/IAS19 level of liabilities. While BrightonRock does not encourage schemes to over-fund, it is possible that the investment performance of a scheme may have this result. Above this level, a scheme represents no immediate risk to BrightonRock, since as a low cost provider of annuities it can execute full annuitisation at these levels. BrightonRock's ethical and governance policies dictate that all risks faced by it be fairly priced. The premium will reinstate at prior levels when over-funding declines below this level.
20. All premiums paid to BrightonRock, but not the investment income arising from them, will be credited against the cost of any elective scheme annuitisation. This gives schemes the comfort of knowing that, where their sponsor has not failed, premiums have not been entirely “wasted”.
21. A final demonstration of the affordability of the BrightonRock contract can be found by comparison with competitors. Rightly or wrongly, consultants have

¹⁴ The Dead Zone diagrams illustrate this point.

¹⁵ Through the lens of the PPF the BrightonRock contract will be a type C(i) evergreen contingent asset.



already put BrightonRock and Tactica in the same category¹⁶. Tactica has a product “guaranteeing both cash flows and assets equal to IAS19 liabilities at all times for a ten year period¹⁷”. The premium is two to ten times BrightonRock’s: “Firms will pay a flat annual fee of 1% of the value of the pension fund¹⁸”.

Transparency gained

22. BrightonRock’s contract represents reinforcement of the sponsor covenant for trustees, backed by its financial resources and full credit-standing. Obviously trustees will be anxious that BrightonRock should remain well managed. But should the credit standing of BrightonRock decline, trustees can always transfer a scheme out of coverage¹⁹. **This possibility will ensure that BrightonRock is managed to the highest standards; it is exposure to market discipline²⁰.**
23. The BrightonRock contract is an asset of the scheme, which for most schemes will have positive initial value²¹ and this value will change according to the evolution of the sponsor covenant. The greater the current size of the sponsor covenant, the greater will be the value of the BrightonRock contract as an asset of the scheme. As an asset, it will be valued periodically, and its value and value for money will be transparent to the trustees. Its value will be highest in difficult and distressed times - precisely when this is needed.
24. A differentiator of BrightonRock from other new products for DB schemes is that its design is truly market-led and not industry-led²².
25. BrightonRock’s management policies place great emphasis upon the concept of treating customers fairly and to achieve that it offers enduring continuity, security, transparency, flexibility, value for money, and affordability.

¹⁶ For example, “Accentuate the positive on pensions”, FTfm, 19 November 2007

¹⁷ http://www.pensionstrategies.co.uk/solutions/insured_investment_option.htm

¹⁸ http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article2510925.ece

¹⁹ A GN16 transfer to a mirror image scheme is one such approach.

²⁰ No insurer wants to see clients voting with their feet and the enduring nature of the BrightonRock contract means that client defections would have a particularly pronounced effect on shareholder embedded value.

²¹ This is unusual but arises from the expected recovery of the Section 75 debt post insolvency and the risk sharing inherent within the BrightonRock structure.

²² The expansion of bulk pension annuity that we see currently is also industry-led.