Nest protection

From Britannic Group's perspective there are three key benefits to the way the pension scheme was restructured. These are general financial benefits; benefits that apply specifically for insurance companies; and employee relationship benefits.

GENERAL FINANCIAL BENEFITS TO THE COMPANY General financial benefits to the company are straightforward and would accrue to any UK company that sponsors a defined benefit pension scheme, whether open to new members or closed. Pension scheme investment strategies affect the company balance sheet, cashflow and pension expense. This will become more apparent to investors under FRS17 *Retirement Benefits*. Britannic Group was keen to deal with potential issues arising under FRS17 as soon as possible.

In analysing Britannic Group's own pension scheme it became clear to us that it was much more exposed to interest rate changes and the effect these had on the actuarial calculation of liabilities than we had realised. This arises because of the long duration of the liabilities in schemes which can stretch 40 years or more into the future. Britannic Group was keen to avoid unexpected increases in its company cashflow requirements. It also wanted to avoid investors perceiving unexpected fluctuations in the value of the company as a result of pension scheme surpluses or deficits causing volatility in its balance sheet. Working with the Trustees and their advisors, including Britannic Group's in-house asset management subsidiary, a solution was found which resulted in the Scheme entering into long-term swap arrangements which means that changes in the Scheme's liabilities, driven by changes in long-term interest rates, are directly matched by changes in asset values.

We believe this solution is more cost effective and reflects more closely the actual dynamics of the scheme than the alternative strategy which some companies have followed of moving entirely into bonds. In addition, this strategy allows the scheme Trustees to determine the appropriate investment strategy to follow, which can include investment in 'real' assets such as equities and property. Because of the extent of the funding of the Britannic Group's own pension scheme, it was decided that the appropriate asset mix for the moment would be a combination of properties and bonds, with the latter predominant. This, together with the fact that the bond mandate can be actively managed, allows the creation of additional return within the pension scheme, which in turn will reduce the potential future cost to the company. The scheme is in the fortunate position of currently being in surplus and our solution has both allowed us to consolidate that surplus and given us the opportunity to extend it going forward.

The best solution for each company and each pension scheme will be different but the fundamental structure of a swaps driven overlay together with an appropriate asset mix allows decision making to be taken in a much more coherent framework. By dealing specifically with the volatility of liabilities as interest rates move it is then possible to decide how much of the appetite for risk within the pension scheme should be reflected in asset allocation to more risky assets and the extent to which existing financial surplus or deficit should be consolidated.

INSURANCE COMPANY BENEFITS All companies seek to manage capital efficiently. For UK life insurers, this year sees the introduction of a new regulatory regime. As for others in the industry, Britannic Group's life funds are subject to risk-based capital requirements, a

Executive summary

Britannic Group plc pension scheme has just completed a radical shift in its asset portfolio. It has moved out of equities and into bonds combined with long-dated swaps. The result is that changes in the schemes liabilities are directly matched by changes in asset values.

While each company and pension scheme will have to weigh up the best solution to suit individual circumstances, changes brought about by the Britannic Group have enabled it to place future decision making over issues such as asset allocation into a much more coherent framework.

The effect of the strategy is to cover 100% of the exposure of the liabilities with the underlying asset portfolio actively managed against a benchmark of 30% conventional gilts, 30% index-linked gilts and 40% corporate bonds.

egg

GRAHAM SINGLETON, GROUP FINANCE DIRECTOR, BRITANNIC GROUP PLC EXPLAINS THE IMPORTANCE FOR HIS COMPANY OF THE RECENT PENSION SCHEME.

self assessment of risk called the individual capital assessment (ICA). The ICA should take account of any commitments on the organisation to provide pensions and other benefits for its past or present employees. As a result asset and liability mismatches in the pension scheme can impact on the amount of regulatory capital life funds have to hold. By significantly reducing these asset and liability mismatches within the Britannic Group pension scheme, we have reduced the potential impact on our main life funds.

EMPLOYEE RELATIONSHIP BENEFITS Pension provision is not only becoming a major issue in the financial management of companies but also a significant factor in the relationships that companies have with their workforce. Adopting a matching strategy has a number of benefits. By reducing the volatility of the scheme employees can have more confidence that the benefits promised will actually be

Liability-driven investment in practice

Eddie Middleton, Director of Liability-Driven Investment at Britannic Asset Management, explains how the pension scheme was restructured.

In November 2004 the Trustees of the Britannic Group Pension Scheme implemented a liability-driven investment (LDI) mandate through its fund manager Britannic Asset Management.

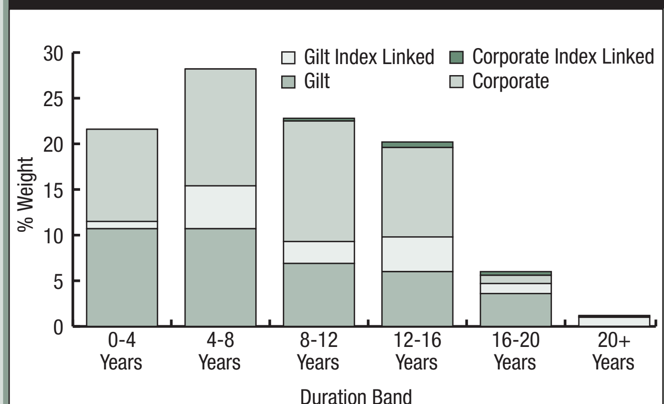
The Scheme's pension liabilities for benefits already promised are a complex mixture of inflation-linked benefits and fixed benefits stretching out many years in the future. The nature of the inflation linkage is slightly more complicated than the typical UK final salary pension scheme, but the overall cashflow profile would be familiar to most UK pension schemes.

The investment strategy prior to November 2004 was more conservative than the industry average with nearly half the assets invested in index-linked and conventional bonds. The remaining assets were involved in equities and property. Despite this conservative asset allocation the Trustees and company had identified that the overall funding level was still potentially very volatile and, as a result, were concerned about this investment strategy. For example, in June 2004 the scheme was fully funded but the investment strategy meant that there was a 1-in-20 chance that the scheme could be only 83% funded by June 2005. The Trustees and company agreed that the investment strategy should be changed both to protect members' benefits and to reduce the volatility of the funding level with its knock-on impact on reported balance sheet figures and on company cashflow. Working with ourselves and the Scheme's consultants, Hewitt, the Trustees and company decided that the liabilities should be made the starting point for the new investment strategy and that we should work to these as their benchmark. This approach is known in the pensions industry as LDI.

Given that the majority of benefits were inflation-linked the first assumption was that a large part of any solution should involve holdings in index-linked gilts and conventional bonds. However all parties were mindful of the fact that the actuarial assumptions for funding included some expectation of returns above gilts and that assumptions about the value of future scheme benefits can change, for example because of increasing longevity. In addition index-linked gilts could not match the inflation-sensitivity of the liabilities precisely both because of the very long-dated nature of the liabilities and the complex inflation linkage of benefits.

This presented us with a problem since, as *Figure 1* illustrates, assets

Figure 1. Duration Breakdown for the UK Fixed Income Market



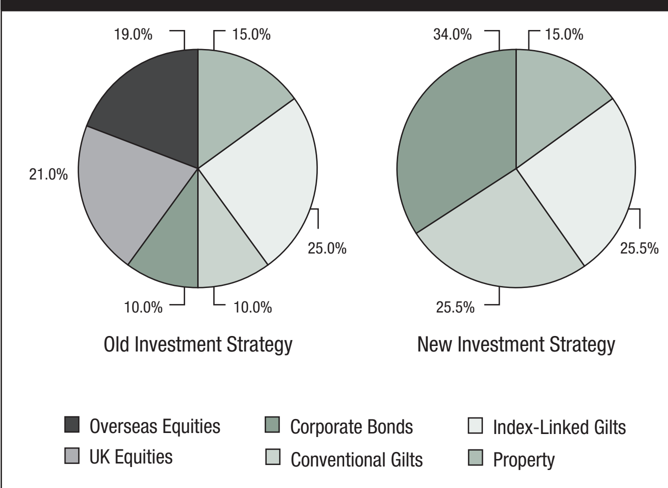
with the right matching characteristics are scarce. Around 90% of the liabilities, in one way or other, depend upon inflation. In comparison just 15% of the UK fixed income market has any inflation linkage. In addition, the Scheme's liabilities, in common with most schemes, have duration (or sensitivity to changes in interest rates) between 16 and 20 years. *Figure 1* illustrates that only around 7% of the market has duration in excess of 16 years while only around 1% has duration in excess of 20 years. Because of demand, assets with these characteristics tend to be both illiquid and expensive. The fact that we are generally paid less for lending for 30 years than we are for lending for 10 years illustrates the scale of the problem.

We needed a method of bridging the gap between available assets and the needs of the pension scheme while retaining the flexibility to add value through active management and also being able to incorporate a proportion of non-bond assets. The assets could have come from any asset class, such as equities, however in this case the Trustees wished to retain the 15% exposure to property because of the above gilt return and the long-run correlation with inflation-linked returns. The Trustees were also concerned that the new strategy should be flexible enough to adapt to any change in circumstances in the future and this structure would allow the interest rate and inflation exposures to be realigned in the event of any changes without disturbing the underlying assets.

The final structure agreed upon consisted of a portfolio made up of 85% bonds and 15% property combined with a portfolio of inflation-linked swaps and interest rate swaps that match the interest rate exposure of all of the liabilities and convert part of the fixed asset flows to inflation-linked asset flows that match those of the liabilities. The effect of the strategy is to cover 100% of the exposure of the liabilities. The underlying asset portfolio is actively managed against a benchmark consisting of 30% conventional gilts, 30% index-linked gilts and 40% corporate bonds. This allows us to add returns through a combination of stock selection and tactical allocation between the asset classes.

The swaps used are a combination of inflation swaps with maturities out to 30 years and interest rate swaps ranging from five years out to 40 years implemented with the Royal Bank of Scotland (RBS). Swaps can introduce credit exposure to the scheme through the risk of default so a collateral arrangement was introduced to mitigate this counterparty credit risk. The amount of collateral held is monitored and adjusted weekly. RBS were chosen as the counterparty because of the combination of their financial strength and their expertise in inflation-linked derivatives.

Figure 2. Investment Strategy Switch



The benchmark used to monitor the performance of the investment manager needed some thought. The complex nature of the inflation-linked liabilities meant that the liabilities on their own without modification could not be used to give the fund manager a clear enough performance benchmark. Instead an intermediate step was created of a liability benchmark portfolio (LBP) where the liability flows out to 50 years were simplified to a series of fixed cashflows, RPI-linked cashflows and Limited Price Indexation or LPI-linked cashflows (here LPI means year-on-year retail price inflation bounded between 0% and 5%). The construction of the LBP bridged the gap between the complex nature of the liabilities and a clear investment manager mandate with transparent performance assessment. Both the bond and property portfolios will be closely monitored against this LBP to ensure that the scheme's assets continue to meet the primary objective of beating the required rate of return while still tracking movements in the value of the assets closely.

The timing of the switch was crucial. The Trustees, in agreement with the company, were keen to achieve a funding level target so that the scheme would be fully funded after completion of the transition. Although the transition was agreed in principle in August 2004 it took until November 2004 before the right combination of equity markets and bond markets came together to allow the transaction to go ahead. From that point on it took two days to complete the entire transaction, involving selling approximately £400m of equities and buying a similar amount of gilts and corporate bonds and executing sizeable inflation and interest rate swaps.

THE FUNDAMENTAL STRUCTURE OF A SWAPS DRIVEN OVERLAY TOGETHER WITH AN APPROPRIATE ASSET MIX ALLOWS DECISION MAKING TO BE TAKEN IN A MUCH MORE COHERENT FRAMEWORK.

delivered and that their contributions are actually adding value. In addition, given that pension benefits have moved up the agenda for most employees, the greater certainty that the future benefits from the defined benefit scheme should be delivered is a major tool in staff retention and, hence, business stability.

PRACTISING WHAT WE PREACH Overall, as Group Finance Director I am pleased with the benefits and additional certainty that result from the pension scheme's new investment strategy. From a business perspective this transaction has much in common with the management of closed life funds, which is one of our core businesses. The careful management of asset and liability risk is a key part of this business and we are fortunate that our asset manager, Britannic Asset Management, has an excellent understanding of the issues involved in managing mandates on this basis. The restructuring of the pension scheme is an extension of our usual business practice and is just an example of 'practising what we preach'.

Graham Singleton is Group Finance Director, Britannic Group PLC.
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