Defined Benefit Solutions

Most Australian Defined Benefit (DB) plans have been phased out in favour of defined contribution, where the member bears all of the longevity, inflation and market risks. However, there remains a significant number of plans with active DB members, where the risk is borne by the corporate sponsor and the fund Trustee. Life expectancies are increasing, equity markets are volatile and interest rates are coming off historic lows.

Even for a DB scheme closed to new members, the long-term nature of these risks may continue to sit with the scheme and sponsoring employer for more than 30 years. Pension risk can have a significant impact on the sponsor's core business and member benefit security. Beyond just ensuring the scheme is fully funded, administration, annual costs, as well as the need for ongoing management focus can create a long-term burden on the corporate sponsor.

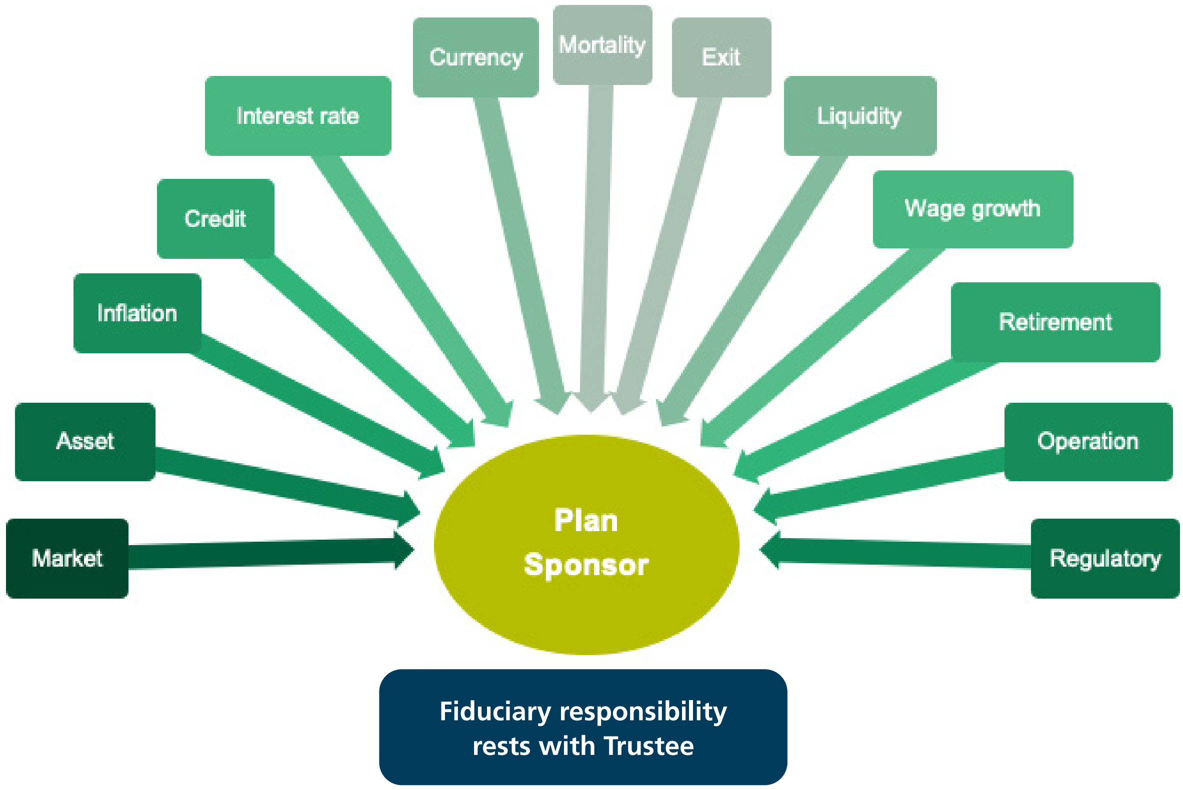
Through 2021 many plan sponsors have experienced the tail winds of strong equity and bond markets and now sit at a well-funded position. With funding levels now at attractive levels, sponsors are reviewing their plans and assessing options to defease liability risks or completely defease the operational burden of their DB plans altogether, in light of these plans being non-core to the sponsors' operating business.

As a result, momentum is building for plans to pursue de-risking solutions.

There are a number of risks that need to be managed

From a Trustee's perspective they are responsible for the member's best interest and that the members accrued benefits are protected. But, Trustees also take on regulatory and operational risks.

For the DB plans sponsors, there are a range of risks that are borne by the corporate sponsor including longevity, investment, and regulatory risk which put pressure on funding levels for the sponsor.



There are numerous innovative ways for plan sponsors to de-risk their DB liabilities, either in part or in full, and these solutions have designs tailored to the funds' needs which are optimised for cost and efficiency.

Defined Benefit pension solution framework

	Liability Driven Investing	Longevity Swap	Buy-in	Buy-out	Successor Fund Transfer (SFT)
Detail	Challenger can assist internal teams with advising and implementing asset & liability management strategies to reduce investment, interest rate and inflation risk.	Fund pays a monthly premium to Challenger Life for an agreed period in exchange for the actual monthly payment for the covered retirees.	The Trustee purchases an income stream to match the DB liabilities, and retains responsibility for administering and reporting the existing accounts.	Challenger Life has full responsibility for meeting all pension liabilities, including investment and administration.	A SFT to the Challenger Retirement Fund, which takes over all ongoing liabilities to the member.
Member relationship	**Super Fund**	**Super Fund**	**Super Fund**	**Challenger**	**Challenger**
Features	• Suitable for active DB pools • Investment risk and liability risk reduced and actively managed • High allocation to risk assets still possible • Not a complete risk transfer • Pension administration remains with Fund	• If covered retirees live longer than expected, CLC covers the difference • DB scheme retains control of the ongoing investment • Only longevity liability defeased • DB scheme retains the direct liability for meeting the DB pension payments	• Investment and longevity liabilities outsourced to APRA regulated counterparty • Maintains existing legal status and grandfathered or Asset Test Exempt (ATE) status • Not a complete risk transfer • Pension administration remains with Fund	• All administration and reporting burden removed • Fund can be wound up with no residual liability • Requires individual annuity purchases • Loss of grandfathering • Member consent required	• All existing pensioners transferred to Challenger, retaining grandfathering • Take over all ongoing liabilities allowing incumbent Fund to wind up all liabilities and administration obligations • Cost incurred to do an SFT • Time and higher complexity of transferring admin • Higher execution risk

For larger plans, there is often a pathway to fully defease the DB plan. This can be phased over time to meet the client's end objective.

Defined Benefit pension solution framework

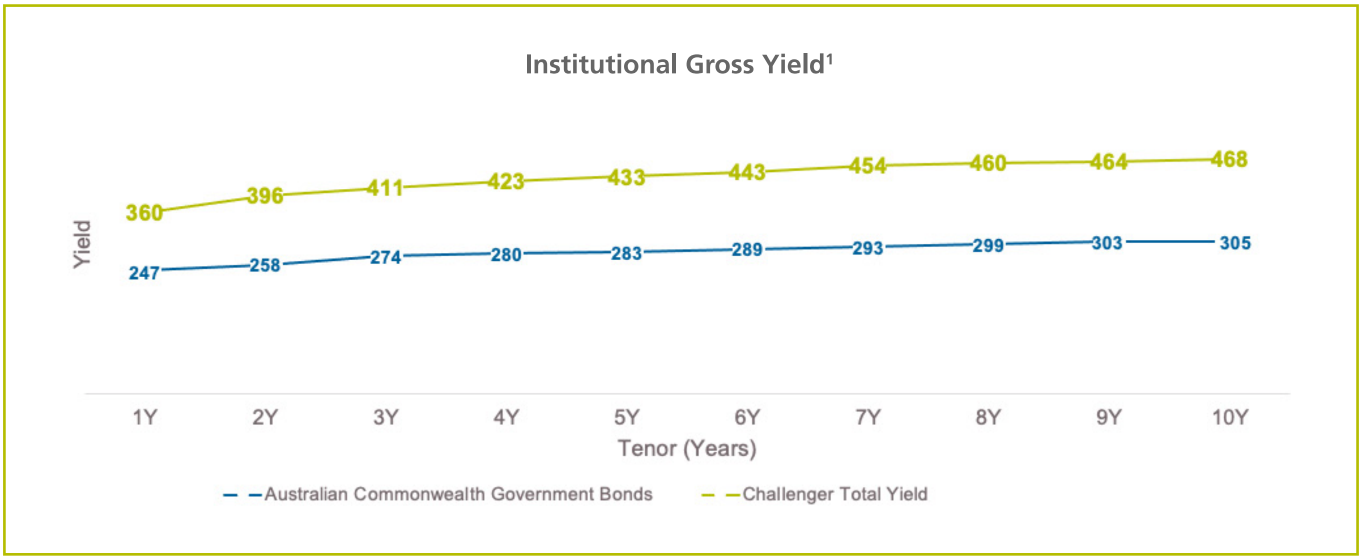
Sequential de-risking for pension pools: Examples

	Phase 1	Phase 2
Liability Driven Investments (LDI) moving to Buy in	Inflation protection investment strategies implemented for DB pool to protect inflation risk.	As majority of members move into pension, the trustee purchases a master policy as an asset to match the majority of their future obligations to retirees. **Objective:** Defease investment and longevity risk but maintain employee relationship and ability to add new members to the master policy as they move into pension.
Buy-in moving to a buy-out via a Successor Fund transfer (SFT)	Implement a buy-in to allow the fund to cater to active DB members moving into pension and then close out the fund when the pool is in pension.	Transfer of master policy to Challenger Retirement Fund via a SFT. Will require a true up in pricing to meet SFT equivalency. **Objective:** Close out the fund with no residual liability.
Initial bulk SFT followed by subsequent SFTs	SFT existing pension members to Insurer's retirement Fund, retaining grandfathering. Continuing to manage the active DB pool until they move into pension.	SFT groups of members periodically as they move into pension. Additional costs incurred and more complexity to meet equivalency for each SFT. **Objective:** Eventually wind up the entire DB pension fund with no residual liability.

As funds begin their glide path to de-risking, they will need to recognise the fair value of their DB liabilities, taking into account all risks exposed to the funds, and to avoid the risk of under-funding. Lifetime solutions provided by Challenger offer better value compared to the risk-free liability values, as they are normally priced at an attractive margin over risk-free rates.

Challenger Term curve

Relative yield advantage



Indicative as at 01 August 2022

Regulatory protections when de-risking with Challenger

Counterparty risk is a key consideration for Trustees. Counterparty risk is near removed on the basis that the pension assets are held in the Challenger statutory fund. This is regulated by APRA under the Life Insurance Act and APRA provides a prudential framework active oversight and a very strong level of protection to our clients as outlined below.

Regulation

- Challenger is regulated by APRA under the Life Insurance Act
- APRA sets prudential standards and monitors compliance with legislation
- Aims to ensure we meet our obligations to investors now, and into the future

Investor security

- Required to hold regulatory capital and additional capital buffers above this
- Regulatory capital is set to withstand a significant market event
- If an adverse event occurs, future obligations are still guaranteed

Safety mechanisms

- Challenger will take action to maintain capital levels above bottom of target range (which is well in excess of the regulatory minimums)
- APRA is authorised to take action if capital falls below the minimum regulatory capital level in order to safeguard the interests of customers

Managing liabilities and assets is Challenger's core business via long term annuities. Challenger's balance sheet has a similar liability profile to a DB plan.

There are a range of de-risking solutions that can be explored depending on what the Trustee and plan sponsor are trying to achieve.

For more information please contact your Challenger Institutional Solutions Group Representative

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