

# Pensions Bulletin

## Fact Sheet I

Summer 2008 Issue 2

### Pension scheme buy-outs

#### I Introduction

1.1 An increasing number of pension scheme trustees are looking to transfer their defined benefit (DB) scheme's liabilities to insurance companies. A recent survey by Lane Clark & Peacock (LCP) has suggested that this 'buy-out' market could exceed £10 billion in 2008, a three-fold increase on 2007.

1.2 There are two main types of buy-out transaction in the current market:

- 'buy-ins' for continuing schemes, and
- full transfers that are designed to give employers a clean break from future pension liabilities.

1.3 This fact sheet outlines how buy-ins work as an investment vehicle for a DB pension scheme.

#### 2 What is annuity purchase (a buy-in) of liabilities?

2.1 Annuity purchase is a type of asset investment (in the same way as equity, property and bonds). Unlike most other investments, it bases the investment on the exact amount required to replicate the liabilities that it is supporting. It is used to remove some of the funding risk (inflation, investment, interest rate and mortality) to which a scheme is exposed.

2.2 We know that different asset classes have different characteristics of risk and return. For instance:

- Equities are very volatile, in that their value fluctuates considerably. But they are expected to give greater long-term returns.
- Bonds have a lower expectation of return than equities but have less volatility of return (and value), though their value does fluctuate with interest rate changes. If the interest rate falls, the value rises.

2.3 The liabilities of a pension scheme (also known as the Technical Provisions) fluctuate in value according to the expected return that might be received in future on bonds and equities. They also change if mortality assumptions change and if the rate of expected inflation changes.

2.4 There are situations where the assets increase in value and the liabilities fall in relative terms. The opposite can also occur. This is the sort of volatility associated with scheme funding. It is desirable to keep this volatility to a minimum to minimise the risk of significant increases in contributions. However, removal of volatility usually comes at the price of a reduction in the expected return.

2.5 A key means of minimising this volatility is to purchase annuities with an insurer.

- This is achieved by replicating the pension benefits through an annuity provider (an insurer) so that the insurer pays the pension scheme the amount of the pension when it falls due. In return for this, the pension scheme pays the provider a premium at the outset, which is the purchase price of the annuity.
- The annuity provider takes on the mortality and interest rate risk that the pension scheme would otherwise bear.
- In minimising this volatility, the pension scheme would lose the potential out-performance that a part of its assets might have gained.
- Note that not all risks can be removed. A small residual risk remains for the Trustee and the scheme sponsor because an insurance company could fail. However, there are strong solvency requirements imposed by the Financial Services Authority and a statutory policyholder compensation scheme, and so this risk is very small.

2.6 If an annuity purchase were to take place, the liabilities for the relevant pension scheme would remain unchanged and members would not be affected. The assets of the pension scheme would be different in their make up and the annuities themselves (which are paid by the provider to the pension scheme) would form part of the scheme's investment strategy in the same way as equities, bonds and property.

### 3 What has changed?

3.1 Historically, the cost of transferring these risks to an insurance company has been prohibitively expensive for many schemes and sponsors.

3.2 A number of factors have combined over the last few months to make annuity purchase a more attractive option:

- The Pensions Regulator now promotes through a Code of Practice and Recovery Plan review, the adoption of more prudent funding targets than were previously the norm. Trustees have been obliged to respond and this has resulted in stronger funding levels, meaning there is now a smaller gap between the on-going and the buy-out levels, particularly for pensioner members.
- Recently there have been many new entrants into the annuity purchase market, which has certainly increased competition. There are now over 15 providers (as opposed to just two).
- Recent evidence suggests that some providers in the market are pricing their bulk annuity business using discount factors linked to corporate bond yields (rather than gilt yields traditionally used by pension scheme actuaries), whilst following the 'credit crunch' there has been a widening of the yield gap between gilts and corporate bonds.

3.3 Although the cost differences (between the Technical Provisions and the market for annuity purchase) have narrowed significantly for immediate annuities for pensioners, bringing them much closer to the liability values of the pension scheme valuation, there is still a noticeable difference between the cost of securing deferred annuities with an insurance company and the pension scheme liability values for most deferred members.

## 4 What are the implications of an annuity purchase?

- 4.1 It is possible that the liabilities for pensioners could be transferred to an insurance company at little or even no additional cost to a pension scheme.
- 4.2 This would mean that most of the major funding risks (e.g. investment risk, interest rate risk, inflation risk and longevity risk) can be removed from the scheme for that part of the liabilities bought-in by the insurance company.
- 4.3 From the perspective of the members, the Trustee would still retain overall responsibility for providing the pension benefit but many of the key risks have been removed.

## 5 Action points

- 5.1 In addition to considering the funding implications, action in the following areas would need to be taken:
  - **Investment advice**

The Trustee would need to take investment advice. This would typically include advice on how best to (a) structure a scheme's assets now in order to 'lock into' the financial benefits of annuity purchase and (b) consider the implications of investment strategy in respect of the remaining invested assets post buy-in.
  - **Approaching the market**

The Trust's actuarial advisor HSBC would approach insurance companies in order to secure the 'best' market terms. HSBC would then prepare a summary of the results for discussion by the scheme's sponsor and the Trustee. Having considered HSBC's findings, the Trustee's Investment Consultant would then prepare a formal recommendation for the Trustee. This would include information relating to the financial strength of potential providers.
  - **Data verification**

Whilst the data in respect of pensions in payment is accurate, some work would need to be undertaken to verify the scheme data, in particular the information held in respect of spouse's benefits (for example obtaining spouse's dates of birth). This data verification may ultimately lead to further cost savings.
  - **Mortality analysis**

Some annuity providers require an analysis of a scheme's mortality experience before providing an annuity purchase quotation. Such an analysis could be worthwhile if a pension scheme's experience indicates heavier mortality than the insurance company had expected (and so could be used to negotiate down the purchase price).
  - **Legal advice**

Advice from the Trust's legal advisors, Linklaters, would also be required in the event that any annuity purchase is considered, to ensure that the principles of Trusteeship are adhered to and that the transfer documentation is properly drafted.
  - **Communication with members**

This must be done via the annual Summary Funding Statement, although it could be done in the Annual Report, or specifically when the investment is made.

## 6 What next?

- 6.1 If a scheme sponsor would like to consider an annuity purchase as an investment for their pension scheme, then please contact your regular Account Manager at The Pensions Trust.
- 6.2 Should a scheme sponsor agree in principle to buy-out the scheme's pensioners then a detailed project plan including budgets would be required. This would be done in conjunction with the Scheme Actuary and Investment Consultant.
- 6.3 A scheme sponsor may also wish to seek its own independent advice on this matter before reaching a decision.

*While every effort has been made to ensure the accuracy of the information contained in this fact sheet, it should not be treated or relied upon as a statement of law. Readers should contact their regular Account Manager at The Pensions Trust in relation to their own circumstances and/or refer to the original source material as appropriate.*