Technical Briefing

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Insuring Scheme Benefits

Background

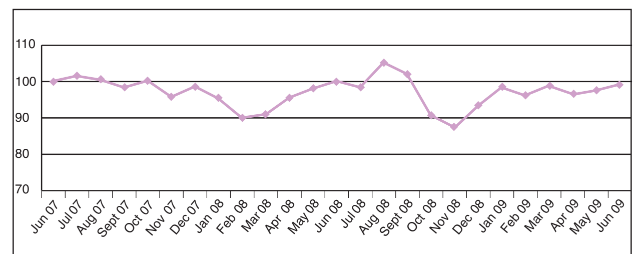
The most straightforward method of discharging scheme liabilities is to secure, or buyout, benefits, for both deferred and pensioner members, with an insurance company. Indeed, on wind up of a defined benefit scheme, this is the ultimate means by which the scheme can guarantee to meet its liabilities.

In general, however, the cost of such a buyout is much higher than the normal assessment of a live scheme's liabilities, referred to as the Technical Provisions under valuation regulations. As such, the cost is generally viewed as being prohibitive. Recent market turbulence and, in particular, historically high corporate bond yields, have however led to buyout costs becoming much more attractive. Combined with relatively recent product developments, including the option of buy-ins as opposed to buyouts, this has led to more schemes considering securing some or all of their liabilities with insurers.

Changes to affordability

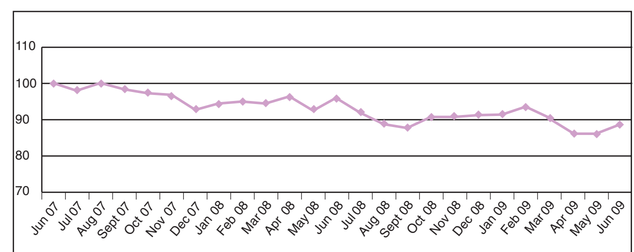
Over the two year period from June 2007, the overall affordability of a typical pension scheme buyout has risen by about 10%. This figure is made up of two components, the affordability for deferred members, who have not yet reached retirement age, and that for pensioner members who are already in receipt of pensions. The following charts compare the relative costs of two typical groups of deferred and pensioner members respectively from June 2007 to June 2009.

Fig 1: Relative Cost of Deferred Member Buyout*



This demonstrates that, over the last two years, although the cost of a buyout at the end of the period was similar to that at the beginning, the cost is volatile, with changes of over 15% occurring over a three month period.

Fig 2: Relative Cost of Pensioner Member Buyout*



This shows a somewhat different picture from that for deferreds, with a relatively steady decrease in the cost to secure pensioner members by up to 15% to the end of May, although as bond yields have dropped back the costs have crept back up.

Activity in the pensioner market in particular has grown significantly. Many more schemes are seriously considering securing pensioner liabilities in 2009.

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How long will this opportunity last?

The cost of securing liabilities is very closely linked to the bond markets, with insurers now more likely to factor corporate bond yields into prices. Bond yields have been at historically high margins over government securities for much of 2009. Some of these margins have relaxed as markets gain greater confidence about the risks of defaults. There will be ongoing volatility in the terms available, especially if ongoing quantitative easing and increased government borrowing conspire to push gilt yields higher over time.

Access to terms

One issue facing trustees considering securing liabilities is access to terms. Given the increasing attractiveness of the market, and the fact that insurers can usually only make capital available to write a fixed amount of business (this is capital hungry in the medium term to meet solvency requirements), insurers will often set minimum and maximum case sizes. Some will only quote for cases over £20m and we have experienced one who will not write anything over £50m. This can change from day to day, however, adding to the volatile nature of the market.

Solvency II

There has been much discussion in insurance circles of late about the impact of European requirements, known as Solvency II, on the capital security required by insurers to write guaranteed annuity business. This has led to some commentators suggesting that the cost of such business might increase by up to 20% over the next two years to meet these requirements. This is another potential reason to seriously consider securing some or all of a scheme’s liabilities sooner rather than later.

Buy-in vs buyout

One of the objections in the past to securing pensioner liabilities was that, if benefits for particular members were secured in full, did that treat them more favourably than those members left behind, without secured benefits, who remained dependent upon the sponsor’s covenant.

The use of a buy-in arrangement for pensioners resolves this issue, making the decision primarily an investment one. Whereas a buyout secures benefits in a member’s name, the buy-in secures benefits in the trustee’s name and pays all instalments via the trustee. Therefore if, for any reason, payments to individuals need to be reduced in the future (for example to meet a PPF level of benefits instead of full benefits), the balance of any instalments are still there as an asset to be distributed to meet other members’ benefits.

Summary

The cost of insuring liabilities has fallen considerably recently and an opportunity may still exist for some schemes to take advantage of this. Rates are potentially rising again, but for many the use of a pensioner buy-in in particular may well be worthy of consideration.

The variation in annuity terms will from time to time change the commerciality of a buy-in exercise. What does not change, however, is the ability of such a process to de-risk a pension scheme in terms of both future mortality and investment risks.

If you are interested in exploring this opportunity further, please speak to your usual cprm contact or telephone Jonathan Black on 0131 338 6127.

September 2009

*Source: Pension Insurance Corporation Risk Transfer Index, August 2009