

PREMIER PENSIONS MANAGEMENT

LEGISLATION UPDATE : 02/07

Buy-out of Pension Liabilities

In the last couple of years a number of new insurers and niche players have entered the annuity business to try and acquire market share in the bulk annuity buy out market

This has resulted in greater capacity and more competitive pricing.

Prior to 2005 the Prudential and L&G dominated the market. The new entrants to the market now include:

Norwich Union
AIG
Aegon
Paternoster
Pension Insurance Corporation
Synesis Life

So what has changed and why is there a sudden interest in this market? Three areas have been identified:

1. Following the introduction of FRS17 pension scheme sponsors realised that the risks from the scheme are significant and can directly impact the Company's finances. Companies therefore began looking to offload their liabilities to a third party.
2. Upward revisions of mortality assumptions. The buy-out of liabilities is the best way to protect the Company.
3. Buy-out is seen as the ultimate way of insuring investment and longevity, without the need for complex investment strategies.

The market has seen the opportunities here with the aim of securing significant economies of scale and hence improving profitability.

However, this does not necessarily mean there will be a significant reduction in the buy-out costs. This is largely dictated by the Financial Services Authority requiring significant reserves to back any liabilities that have been bought out. This is quantified when schemes compare their ongoing and buy-out actuarial valuation figures.

Providing the ability to "mismatch" investment strategy to provide greater returns is also restricted by this.

Early evidence shows that the new entrants have caused a 5% - 10% reduction in the price compared to the old market. However, this is still significantly greater than FRS17 costs on Companies balance sheets., The difference is probably about 30%(depending on the scheme).

The increased competition has had less impact for deferred annuities. These liabilities are more long term in nature and the risks of imposed mortality and falling investment returns are much greater. There is therefore little "price" change in this area.

As well as more options on buy-out there are also other products, the main ones being: -

1. **Partial Buy-out**

Most schemes cannot afford full buy-out, so partial buy-out has been developed. For example the ability to buy-out some or all of the pensioners.

To the insurers this can be a lucrative business, as the risks of mortality and investment charges are at their lowest.

2. **Structured Buy-out**

This allows the transfer to be secured by a programme of successive asset transfers, leaving residual assets in the scheme.

The potential advantage is that the schemes' remaining assets can be invested in potential higher return investments.

This would be particularly useful for Trustees/Companies who are focused on mortality risk rather than investment.

Risk Sharing

For example the Trustees could buy out all the pension liabilities at full cost. The assumptions used for the buy out are then compared against actual experience.

If mortality was heavier than expected a refund would be paid to the scheme and vice versa.

There could also be some sharing of the investment risk.

So what should Trustees and Companies consider: -

- a) Historically, major companies have had pension schemes which have been too large to consider a full buy-out. The new capacity in the market now allows them to get involved.
- b) Increased competition has resulted in lower prices.
- c) Buy-out should therefore be considered when considering risk.
- d) However, any buy-out is likely to cost more than scheme reserves, especially under FRS17. It may still be too expensive for the Trustees (ongoing funding) and the Company (FRS17).

The decision on whether the new market will be of interest will vary from client to client and will largely be dependant on the extent the Company and Trustees are willing to pay a premium to reduce risk.

January 2007