

Assessing Insurer Solvency for a Buy-in

One of the most extraordinary aspects of the global financial turmoil over the last year is the re-evaluation of the risks posed by large financial institutions whose security was previously unquestioned.

The increasing cost and risks associated with defined benefit pension schemes has led many companies to consider buying out all or part of their schemes' liabilities with an insurer. Although this can look attractive financially, trustees and sponsors are rightly concerned about the impact of the chosen insurer if it became insolvent.

Although this concern is extremely relevant it need not prevent a bulk annuity transaction proceeding. The possible effects of insurer insolvency need to be evaluated in the light of the rigorous insurer solvency requirements and other safeguards such as regulatory compensation arrangements.

Bulk Annuities and Insurer Insolvency

One of the most significant risks associated with purchasing a bulk annuity policy is the possibility of the chosen insurer becoming insolvent and defaulting on its obligations at some point in the future, given that a significant portion of the scheme's assets will have been passed to that institution. Notably, a buy-in policy does not discharge the scheme from the liability to pay members' benefits. A buy-in policy is simply an asset of the scheme whose proceeds are designed to match the scheme's liability to pay certain benefits to members. Therefore, if an insurer defaults on its obligations under the policy the scheme will remain fully responsible for providing the benefits. If the policy proceeds cannot be recouped in full the sponsoring employer will ultimately need to make good the shortfall.

There are, however, certain safeguards in place from which investors might take comfort. Insurer insolvency would occur if its liabilities exceeded its assets. The risk of this happening is controlled by the strict reserving requirements of the Financial Services Authority (the "FSA"). These require the assumptions used for valuing liabilities to be prudent and for an additional buffer (or solvency margin) to be held in excess of the assessed value of the liabilities to protect against unexpected market movements.

What assets are insurers required to hold?

The FSA monitors the level of capital that insurance companies hold and requires them to have assets equal to the higher of two 'pillars'. These measures are designed to ensure that insurers are financially strong and able to meet their liabilities.

Pillar 1 – Capital equal to a prudent estimate of liabilities, plus a solvency margin of roughly 4%. In practice, most insurers would hold a larger buffer to protect against market fluctuations causing the 4% margin to be breached.

Pillar 2 – Capital required for an insurer to survive adverse events that are considered to occur once in 200 years.

Insurers typically invest the capital backing these pillars in assets that very closely match the movement of their liabilities. For example, insurers are very reluctant to hold equities to back their annuity liabilities as the equity market's performance does not provide a reasonable match to the likely movement of annuity liabilities and, as such, they would be required to hold additional capital to back the extra associated risk.

By comparison, pension schemes are permitted to be underfunded whereas insurance requirements do not permit this for insurers who must always hold capital in excess of the full value of their liabilities.

How does the FSA regulate insurers' capital requirements?

If the financial position of an insurer declines significantly, there are a number of ways that the FSA can intervene. The FSA can instruct the insurer to stop writing new business in order to protect its existing business and ultimately the insurer may have to raise new capital. It is unlikely that the FSA would wait for a breach of the solvency margin before they intervened, instead entering into non-public discussions with the insurer when it appeared that a problem was emerging. The FSA keeps up-to-date with insurers' solvency margins through regular reporting and is believed to have conducted negotiations with at least one insurer recently.

In the event that FSA intervention was unsuccessful and an insurer is declared insolvent, a further level of protection is offered to policyholders of UK insurance companies by the Financial Services Compensation Scheme (FSCS). The FSCS would step in and currently provides policyholders with at least 90% of the value of their policy with no upper payment cap.

There was some uncertainty about whether the FSCS would cover a buy-in policy but the Association of British Insurers has apparently recently received confirmation that this would be the case. There is some concern, however, that the FSCS has not yet been tested and that it may not cope with the insolvency of a major insurance company. In addition, claiming for compensation is likely to be a long process. We understand that the FSCS would only pay out once an insurer has completed a liquidation process as it is only then that the amount of policyholders' losses could be assessed with certainty. In the mean time, policyholders' benefits would be frozen.

There is no doubt that insurance companies have been financially tested in recent times and there is also no guarantee that the FSA would be alerted in time to an emerging issue regarding an insurer's solvency position. Nonetheless, we believe that pension scheme trustees and sponsors can take some comfort from the regulatory regime within which insurers must operate and can view purchase of a buy-in as a means of reducing the overall risks associated with their scheme.

What would cause an insurer to get into financial trouble?

An insurer may get into financial difficulty for a number of reasons which might equally apply to the pension scheme had a buy-in policy not been purchased. We have considered two possible scenarios below:

Corporate bonds issued by commercial organisations make up a significant proportion of the asset portfolio of many insurers. These are seen as a riskier asset class than Government bonds due to the greater risk of the bond issuer defaulting. There has been a relatively small number of actual corporate bond defaults during the recent financial crisis but the perceived default risk led to a significant fall in corporate bond valuations. This reduced the solvency positions of many insurers. Any pension schemes that were holding corporate bonds would have seen a similar reduction in their assets at the same time.

Longevity risk is currently a much debated issue in the pension sector given that pension scheme liabilities increase as members' life expectancy increases. The liability to provide benefits to a pensioner increases by approximately 3% for each additional anticipated year of life so longevity risk is a

real concern to those responsible for providing pensions. While the liabilities of both insurers and pension schemes make allowances for long-term improvements in life expectancy, these estimates are very uncertain. If future life spans prove to have been underestimated insurers' reserves will be inadequate and will need to increase. However, this would apply equally to pension schemes that will have seen a similar impact on their finance position.

It is also worth noting that some insurers writing annuity business also write life assurance policies. This has a reverse risk profile compared with annuity business, being exposed to shorter rather than longer life expectancy. Therefore, longevity risk may be partially offset by such business.

Summary

Insurance companies are required to hold significant reserves to back bulk annuity contracts. The reserving requirements are more onerous than those required for a pension scheme.

Trustees and companies are rightly concerned by the financial strength of insurers when considering a buy-in. However, the risks of insurer insolvency should be considered in the light of the events that might lead to an insurer getting into financial trouble and compared with the position of the pension scheme had the buy-in policy not proceeded.

The FSCS might also be a comfort in the event that an insurer was unable to meet its obligations. Ultimately the trustees would look to the sponsoring employer to meet any shortfall in a scheme assuming it was solvent. In the event of insolvency of both the insurer and the sponsoring employer, the trustees would look to the Pension Protection Fund to provide security for members' benefits, albeit at a reduced level.

There are other measures that can be taken to manage the risk of insurer insolvency, such as spreading any buy-out or buy-in across several insurers or collateralising the transaction. Although the position cannot be absolutely guaranteed, the above safeguards can give trustees and employers some comfort when considering the option of a buy-in. It is essential to look at each case individually and the financial position of a shortlisted insurer should be reviewed at the time of a buy-in.



Barnett Waddingham - NOVEMBER 2009

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