

Reducing Pensions Risk – Ready to act?

Companies need to be able to take advantage of opportunities to de-risk their pension schemes as they arise. Markets are fast moving and attractive opportunities can disappear quickly – possibly before they have even been identified. One of the primary options available to companies looking to reduce their pension risks is a bulk annuity policy (commonly referred to as a buy-in contract). The bulk annuity market has expanded in recent years driven by increased competition and price reductions.

Does it make financial sense to purchase a buy-in policy?

From a cost perspective the attractiveness of a buy-in policy will be influenced by two main factors:

Investment strategy – The investment return underlying the price of a buy-in contract may be similar to the return expected from a portfolio of gilts and corporate bonds held within the scheme. A scheme with a significant holding in bonds designed to back pensioner liabilities could find a buy-in policy particularly attractive. There will always be some mismatch between a scheme's bond assets and the pensioner liabilities even if a full liability-driven investment strategy has been adopted so the affordability of a buy-in will change over time.

Life expectancy – The life expectancy assumption underlying the pricing of a buy-in policy compared with the company's own best estimate of the life expectancy for the scheme members will also be key in determining the attractiveness of the policy. The only way to make this comparison is to obtain a quotation from an insurance company.

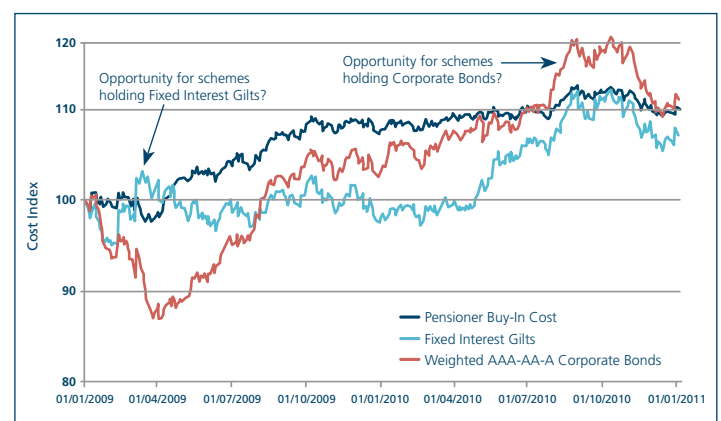
Barnett Waddingham has systems in place to carry out a quick and cheap initial buy-in viability assessment without committing to a large, detailed project.

Monitoring the affordability of buy-in

Bulk annuity prices vary as market conditions change. With volatile financial markets the affordability of a bulk annuity

policy, in light of the scheme's asset values, can change very quickly and there may only be a short opportunity to make an attractive transaction.

The graph below gives an indication of how buy-in pricing for a sample pensioner group has changed during 2009/10 and how a typical scheme's bond assets may have moved over the same period. This shows that there can be significant volatility in affordability, even compared with investments that are often described as a good match to these liabilities.



Source: Barnett Waddingham LLP Internal Model

The graph shows that, for a scheme holding a significant proportion of corporate bonds, a buy-in is likely to have been more attractive in late 2010 than it was before then. By contrast, there may have been a window of opportunity during March 2009 for a scheme with significant gilt investments to make a favourable buy-in purchase.

As well as changes in market conditions, other issues can affect buy-in pricing and again offer opportunities to pension schemes in a position to take advantage of them. For example, early 2008 saw particularly attractive pricing as new providers sought to establish themselves in the market. On the other hand, an area that may increase pricing is the forthcoming implementation of the “Solvency II” requirements which could lead to an increase in the reserves that insurers need to hold.

The attractiveness of a buy-in policy will vary over time. This will vary from scheme to scheme and depend on the scheme’s membership profile, benefit structure and investment strategy. Monitoring the position can only be done on an individual scheme basis.

By establishing a monitoring process, the company will be better able to take advantage of opportunities when they arise. This need not be a complicated and expensive process. Barnett Waddingham has an in depth knowledge of the bulk annuity market, allowing us to track pricing on a daily basis in the context of individual schemes’ liabilities and assets. Triggers can be set based on the company’s objectives to indicate when a transaction might make sense. Some example triggers could involve:

- Comparing the buy-in cost with the value of a pool of assets notionally backing the liabilities to be covered by the buy-in policy;
- Comparing the buy-in cost with the “Scheme Funding” or “Best Estimate” reserve for the liabilities to be covered by the buy-in policy.

Be ready to transact

It is important that companies and pension schemes are in a position to transact quickly once an opportunity has been identified.

Insurers do not usually provide formal buy-in quotations very quickly – it can be a matter of months for a quote to be produced, although indicative figures can be provided more quickly. Insurers may even decline to quote for a smaller scheme (e.g. a transaction under £20m) particularly during busy periods. A company that seriously wants to transact at the right price should ensure the ground work has been carried out in advance and a quotation can be updated rather than having to be prepared from scratch.

The company should also ensure that the trustees have been consulted in advance and any concerns about a transaction have been addressed so that delays at the final stage are avoided. A significant problem in finalising a deal can be data problems and it is important to ensure that the scheme’s member data is sufficiently accurate. Unfortunately, many schemes often have old, inaccurate or incomplete records and it may make sense to deal with this at outset.

Summary

Many companies and trustees would like to reduce their pension risks and a buy-in policy is one of the best ways of achieving this. The costs of a buy-in transaction can vary significantly over time and it is important for schemes to be positioned to take advantage of attractive opportunities as and when they arise.

For further information

Please contact your usual Barnett Waddingham consultant if you would like to discuss this issue in more detail.

Alternatively please contact:
CorporateConsulting@Barnett-Waddingham.co.uk

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Chalfont Court
Hill Avenue
Amersham
HP6 5BB
Tel: 01494 788100
Fax: 01494 788800

Silver Springs House
2 Topaz Way
Birmingham Road
Bromsgrove B61 0GD
Tel: 01527 300 000
Fax: 01527 300 090

St James’s House
St James’s Square
Cheltenham
GL50 3PR
Tel: 01242 538500
Fax: 01242 538501

163 West George Street
Glasgow
G2 2JJ
Tel: 0141 243 4400
Fax: 0141 243 4432

West Riding House
67 Albion Street
Leeds
LS1 5AA
Tel: 0113 394 3700
Fax: 0113 394 3760

Port of Liverpool Building
Pier Head
Liverpool
L3 1BW
Tel: 0151 235 6600
Fax: 0151 235 6640

Cheapside House
138 Cheapside
London
EC2V 6BW
Tel: 020 7776 2200
Fax: 020 7776 3800

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