

Assessing value-for-money in annuities

Myles Pink gives a guide to best practice



Bulk annuities are increasingly viewed as another asset class that trustees could transition funds into on their de-risking journey. When considering purchasing a bulk annuity, trustees want to assess whether it offers an appropriate level of risk removal at the cost charged by the insurer, compared with the assets it is earmarked to replace.

Any pension scheme's asset allocation decision should start with a comparison of the incumbent and the new assets' characteristics versus those of the liabilities. Over recent years, many pension schemes' starting point for assessing a new asset has been a comparison with gilts.

The comparison can be considered in a number ways:

- Benefits payable in the future by a pension scheme will be affected by how long people actually live, including second lives (i.e. spouses). *Annuities match these payments but gilts cannot respond to increasing life expectancy.*
- UK pensions usually incorporate complex pension increases which are difficult to hedge. Index-linked gilts provide some matching but leave the pension scheme exposed to deflation risk. *Annuities on the other hand are usually designed to match precisely the pension increase exposure inherent in the liabilities.*
- Gilts can provide a good hedge against interest rate risk and a high certainty of return. However, they are less effective in cash flow matching portfolios and this brings reinvestment risk. *This risk is removed by an annuity.*

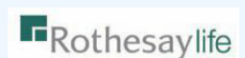
Annuity pricing is more transparent now than it was five years ago, largely because of developments in the markets for reinsuring longevity and hedging other risks.

- There is now a market for insurers to hedge longevity and second life risks. The cost of hedging pensioners in payment is typically equal to an annual deduction to asset returns of 30 to 40bps a year.
- The LPI hedging market is less active but implied pricing is broadly 10 to 20bps each year more expensive than a pension scheme's typical assumptions for RPI-based pension increases.
 - The cost of reinvestment risk is harder to quantify and pension schemes typically do not tend to reserve for it.

It is evident that the difference between the protections offered by a bulk annuity versus gilts could be in the range of 40 to 60bps of return each year.

Provided trustees satisfy themselves that annuities bring improved matching to their liabilities with equivalent counterparty risk (when compared with gilts), it should be attractive to exchange gilts for an annuity with an implied yield of better than "gilts minus 40bps". Most bulk annuity transactions agreed over the past five years have been struck at better levels than this. We expect to see a continued trend in the exchange of gilts for annuities. ■

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5 OPTIONS

"People are starting to take more directional views in the rate market and the inflation market, because they need to," says David Hickey, a director in the institutional team at asset manager SEI. One of the more sophisticated ways of achieving this is through the use of options, which many schemes have shied away from because they are difficult to price and relatively illiquid. **Options are contracts which confer on schemes the right to buy or sell at a set price**, protecting them against significant shifts in inflation or interest rates. They are based on a market view, for example that interest rates are going to rise. The advantage is that "you can use them to take a calculated exposure that if interest rates go up you want to benefit, but if interest rates go down you don't want to get hurt," says Hickey.

4 MULTIPLE BUY-INS

Buy-ins are a well-trodden path, but the sector is only now waking up to the fact that many schemes will have completed a series of such exercises before they can afford a full buyout, says Andrew Waring, chief executive of the Merchant Navy Officers Pension Fund (MNOF). This means there will be a need for consolidation as schemes become better funded, because members' savings may be insured by a number of different providers. As the scheme moves towards full buyout, they can help the funding situation

by arranging buy-ins of certain sections of the fund – in the MNOF's case it was the Old Section, which was closed in 1978 – and **tailoring their investment strategies to meet their remaining funding needs**. The question is funding strategies that can be developed around this multiple buy-in approach. Waring says trustees can either follow a cautious approach to achieve full settlement, or insurers may take some investment responsibility from the trustees earlier so that the same goal can be reached.

