Getting ready for bulk annuities

Myles Pink identifies some trends in the bulk annuity market and identifies ways in which trustees can prepare their scheme so that they are ready to carry out a transaction

What trends are you seeing in the bulk annuity market at present?

The state of pension scheme solvency is currently one of the main impediments to completion of bulk annuity deals (i.e. buy-ins and buyouts). In part this is being driven by record low real yields. Some trustees are asking themselves whether it is even appropriate to evaluate their scheme liabilities using prevailing discount rates. Pension schemes that were not hedged against falls in real yields are at present likely simply to sit it out and wait for a rise – some consider this rise may be some time in coming.

I think a rise in real gilt yields of between 50 and 75 basis points should bring a number of pension schemes back to the market. But until then, where are we likely to see interest in bulk annuity transactions coming from?

● One obvious source is pension schemes that have been invested in gilts over the past year or so and were therefore substantially immunised from the effect of falling yields in the second half of 2011. It appears that multiple billions of pounds of pension scheme assets and liabilities are in this position.

● Another driver of de-risking volumes results from the current availability of cash on corporate balance sheets. Many corporates seem reluctant to invest heavily at present – they are nervous about overstretching themselves in areas such as production growth or M&A activity, in case the economy fails to pick up soon. So, one thing they are turning their attention to is assessing whether reducing pension scheme risk is a good use of their finances.

● In addition, we are seeing some companies struggle in the current economic environment and some of those will go out of business. However an insolvent company does not necessarily have a grossly underfunded pension scheme. Schemes that are sufficiently well-funded will have to buyout, rather than fall into the PPF.

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● One further trend is improved trustee education. As trustees become more aware of the volatility and quantum of the risks they are holding in their scheme, they are becoming increasingly interested in solutions for removing those risks. While that includes partial solutions, such as LDI or longevity swaps, we see trustees continuing to consider an insurance buyout as the optimal end-game because it leads to full risk removal for the pension scheme and sponsor.

What are some of the steps that trustees can take to prepare for buyout?

There are four key steps for trustees in planning towards buyout.

1. Address potential issues within the structure of the pension scheme. These could include:

– Closing to future accrual.
– Potentially simplifying complex pension increase rules and other benefit structures.
– Tidying up data, especially information such as spouses' benefits and data.
– Improving scheme experience data – for example, how often benefits are paid out to spouses after the death of the primary member.

2. Be fully engaged with the scheme sponsor. The sponsor and trustees need to have well-aligned objectives. The corporate sponsor should also have a good idea how much it wants to spend in order to remove the pension scheme risk.

3. De-risk the scheme's asset strategy. Trustees and sponsors should seek to stabilise the pension scheme's funding levels as they move towards buyout.

4. Take the time to understand insurance companies, the way they are managed and how they are regulated. It's unlikely that a trustee board could reach a decision to buyout its pension scheme simply on an opportunistic basis. It's important to understand how insurance companies work, how the Financial Services Authority (the "FSA") regulates them and how that regulation encourages the way in which risks are managed.

With that homework done, trustees and sponsors can approach buyout providers confident of the terms they are looking for and the price they want to pay for those terms. Insurers can then carry out some modelling to confirm whether we think a scheme's assets are sufficient and we can monitor them relative to our pricing over time.

Once all the preparatory work has been done, the markets can then provide attractive opportunities to transact. For example, those schemes invested predominantly in gilts will witness a cheapening of annuity pricing relative to their asset portfolio when credit or liquidity spreads increase. Last year, we executed a buyout transaction for one of our clients within hours of their price target being hit – but that was only possible because all the background work had been completed well in advance and the scheme was ready to optimise its market timing. ■

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