



# PERSPECTIVES ON THE PENSION INSURANCE MARKET

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**Like** the previous year, 2012 ended with a flurry of deals in December as pension funds and insurance providers sought to complete their derisking transactions before the holiday break. Total volume of pension fund bulk annuity deals looks like it will be around £4bn, a little down from the £5bn completed in 2011 and a good result given the strong headwind of low interest rates that weakened most funds' solvency levels. Time also needed to be spent on funding negotiations and auto-enrolment instead of de-risking activities.

Within this £4bn the volume of deals that covered just the pensioners rather than the full membership rose to being above 50% again. Although the long-term multi-year trend is strongly towards full buy-outs, the low level of interest rates and larger size of deficits deterred some corporates from funding their shortfalls ie from investing the deficit at these levels of interest rates. It was notable that the larger full membership deals of the year did not involve additional funding (MNOPE, GM). There was also a lack of any large full buy-out deals from funds in PPF assessment (e.g. like Uniq and T&N in 2011).

Insurance pricing was however good relative to gilts particular in the summer of 2012 and only time will tell whether corporates with strong cash balances or the ability to borrow at these low levels to fund a deficit will reflect on yet another missed opportunity to settle their legacy liabilities.

The attractive pricing relative to gilts did however lead to a strong focus on pensioner only transactions where pricing in many cases was less than a Technical Provisions reserve for the pensioners albeit using a gilt-flat discount rate. This made a switch from gilts to a pensioner-only bulk annuity the dominate theme of the year.

### **2013 - a recovery in confidence?**

The New Year has brought a change in senti-

ment with equity markets and interest rates significantly up at the time of writing. If this continues then we should expect to see more full buy-outs this year. Perhaps, we will also see more corporate borrowing to fund deficits and thereby gaining the benefit for shareholders of the ability to earn a gross roll-up of investment returns instead of the return on the company's assets which suffers corporate tax each year. We've also seen a general increase emerging in corporate confidence since the summer and a greater willingness to complete deals of any kind – something that was lacking in the first half of 2012. As this feeds through to more corporate sales and purchases, settlement of the pension liabilities will feature in some cases as a way to facilitate deals.

### **Pension Deficit Restructuring**

There are a number of situations where it seems unlikely that the trustees can ever pay full benefits due to the weak sponsor covenant relative to the buy-out deficit. Whilst these funds may have been staggering on to earn greater PPF compensation for the many and in particular for the few who can avoid the compensation cap by passing NPA, the situation is often not sustainable. Improving solvency levels and outlook for the business value will in some cases lead to the fund being able to insure more than PPF compensation. Instead of enabling the status quo to carry on for longer, this will mean that the members will have something to lose (i.e. the coverage may fall back below PPF). The risk of losses for the members will lead to deficit restructuring for some of these pension zombies. In some cases (like Uniq) the separation of the successful business from the overwhelming burden of the contingent s75 pension claim is likely to lead to full insurance of the benefits.

### **Pensioner buy-ins – an asset class**

Whether full buy-outs grow significantly or not we will continue to see pensioner-only deals. Funds that approached the market in 2012



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seemed to be better prepared than in previous years and this is resulting in reduced execution timelines. With quicker execution, funds will increasingly focus on being opportunistic, setting de-risking triggers for executing switches into annuities at optimistic pricing levels.

There are also signs that bulk annuities are now being viewed as a better version of LDI investment and included in asset allocation reviews and decisions with two consequences

- The economics of annuity prices will be compared to the risk-adjusted returns available from other asset classes
- The size of the annuity transaction will not be driven by the size of the pensioner liabilities

On the latter point 2012 saw the emergence of more considered approach to partial pensioner buy-in deals that are sized and structured to reflect the amount and duration of the gilts being exchanged for an annuity. The key features here are to make sure that a partial pensioner deal does not make completing a subsequent deal harder or more expensive than it would otherwise be and that the risk management

benefits of any long-duration gilts are not lost in exchanging them for an annuity.

#### **Longevity Hedging**

Longevity-only deals saw a significant decline in 2012 with just two large transactions (Akzo and LV=) totalling £2.2bn down from £7.0bn across 4 deals in 2011 despite continued significant appetite from reinsurers. In my view longevity hedges will however only be of any real interest to the very large funds that have enough resources to run their own sophisticated risk management and are unlikely to need to assign into individual annuities or wind-up for many decades.

At a present value cost of typically around 5% over the pensioner liabilities based on best estimate assumptions there are not many who will see a convincing cost benefit equation in hedging longevity alone. Funds that are not de-risked will likely focus on other risks first unless the long-awaited “capital markets” solution manages to reduce hedging costs. Don’t hold your breath.