Institute and Faculty of Actuaries

Pensions Conference 2013

Buy-ins and buyouts: what should really matter to pension schemes?

Ben Stone, Towers Watson
Sammy Cooper-Smith, Rothesay Life

06 June 2013

Agenda

- Setting the scene – why do pension schemes purchase bulk annuities?
- What really matters? (1): Pension Increases
- What really matters? (2): Security

Institute and Faculty of Actuaries

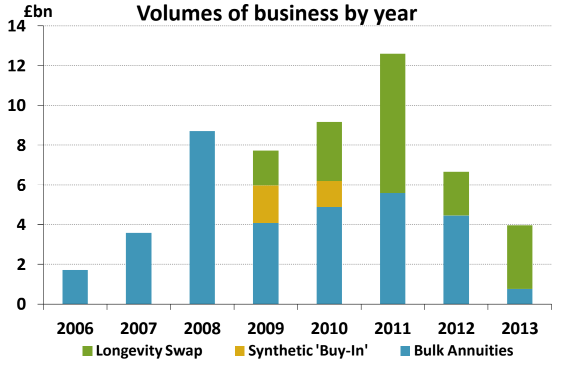
Institute and Faculty of Actuaries

i. Setting the scene – Why do pension schemes purchase bulk annuities

06 June 2013

Market Update – Annuity Transaction Volumes

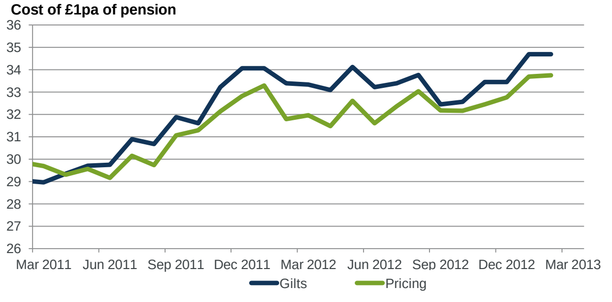
- The entry of new players in 2007 stimulated more transactions and larger ones
- Over £30bn of buy-in and buyout deals completed in this period
- Provider market has increased and decreased over the period and is now segmented



Institute and Faculty of Actuaries

Why do pension schemes enter the buy-in and buyout market?

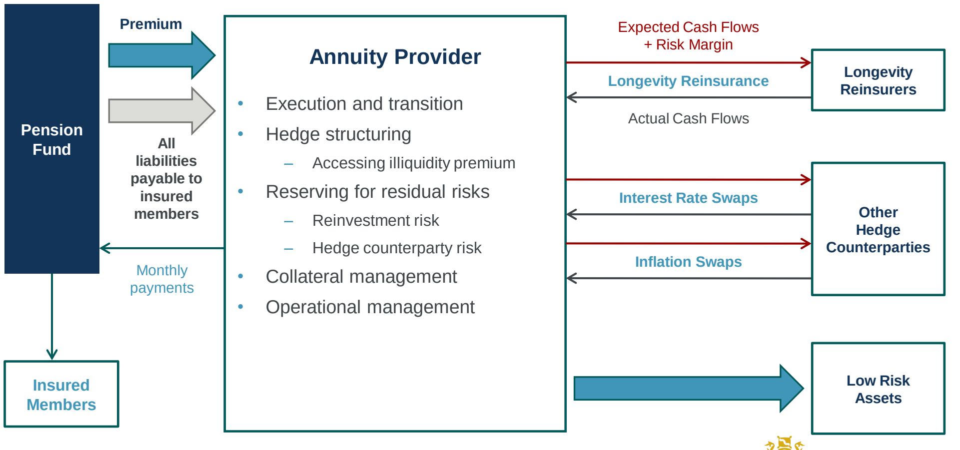
- Scheme buyout. If affordable, why not?
- Partial buy-in. Route to buyout or market opportunity? Recent focus has been on exchanging gilts for bulk annuities held as pensioner buy-ins
- Self-sufficiency. LDI strategy and consideration of a longevity swap?



The reasons for buying a bulk annuity will determine which aspects of the contract are important to the pension scheme

Institute and Faculty of Actuaries

How Insurers Manage Themselves to Provide These Protections? – Buy-in



Institute and Faculty of Actuaries

Institute and Faculty of Actuaries

ii. What really matters?: Pension Increases

06 June 2013

Pension Increases

Annuity pricing includes the costs of guaranteeing the relevant pension increases…

Types of Increases

- Typically based either on CPI or RPI, but occasionally fixed
- Annual increase caps of 2.5%, 3%, 5%
- Annual increase floors of 0% (i.e. no pension reductions)
- Occasionally, an annual increase floor of 3%

Incomplete Hedging Markets

- Lack of CPI gilts means CPI swaps have very high charges
- No natural counterparty for pension increase caps and floors (i.e. LPI)
- Pension funds tend to view CPI and LPI swaps as poor value

Matching Considerations

- Bulk annuities have typically been structured to match the increase
  - Important on buy-out/ assignment
- Does mismatching pension increases prior to buy-out improve the risk/ reward trade-off ?
- What are the consequences of mismatching?

Institute and Faculty of Actuaries

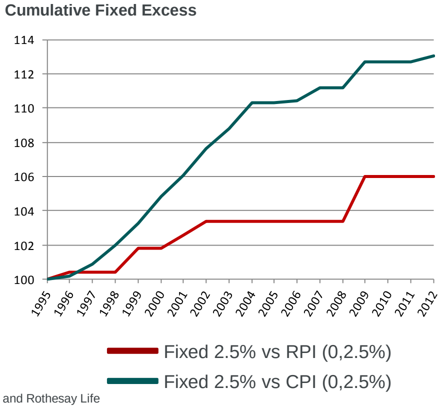
Institute
and Faculty
of Actuaries

03 May 2013

Example – LPI (0,2.5)

- Increases for post-2005 pensions are capped at 2.5% a year
  - 2.5% cap is also applied to PPF compensation
- The chart illustrates how a fixed 2.5% increase compared to the RPI or CPI capped increase

Fixed 2.5% vs. LPI (0,2.5)



Source: ONS and Rothesay Life

How much more would you pay for fixed 2.5% increases?

Note: Past performance is not reliable indicator of future results

Institute
and Faculty
of Actuaries

Concerns from Annuity Mismatching

Issues	Possible Solutions
• Does it block wind-up and buy-out/assignment? • Can we amend the contract in the future on fair terms to reflect the right increases?	• Incorporate flexibility in the contract to amend to the required increase – Can use trader-sourced swap pricing to define contract adjustments
• Annuity surrenders are difficult to achieve, what if it results in over-insurance?	• Prevent the loss of value from over-insurance by initially insuring less than 100% of the benefits
• If we start with x% of the benefits how do we ensure we get fair value on the upsize to 100% on the way to buy-out	• Start close to 100% to reduce the issue – insure 90% of LPI(0,2.5) with fixed 2.5% • Obtain pricing tension from other insurers – insure 50% of LPI(0,5) with pure RPI leaving a significant size to do

Mismatching issues can generally be solved but schemes still need to appreciate the illiquidity of a buy-in purchase

Institute and Faculty of Actuaries

Assessing Protections Afforded to Insurance Policyholders

When annuities are purchased, a number of valuable protections are provided that can be expected to result in the insured members receiving their pensions into the future with a high level of security

Layers of Insurance Protection

- Strong Risk Management Capabilities
- Prudent Assessment of Liabilities
- Regulatory Capital Buffers
- Excess Assets
- PRA Monitoring
- PRA Intervention
- FSCS

For Buy-ins: Sponsor and PPF Protections

Low Probability of Default

+

High Expected Recovery

Institute and Faculty of Actuaries

Selected Features of Past Requests for "Additional Security"

When "additional security" has been requested, it would have involved close monitoring of assets paid across, regular top-up and expectation, on surrender, of rapid recovery in a manageable form

- Premium assets to be held, managed and monitored in a Segregated Account
  - Ring-fenced on insurer's balance sheet?
  - Under trustees' legal title?
- Over-collateralisation to protect against asset price shocks
- Frequent liability revaluation
  - Approach to updating assumptions?
  - Dispute mechanics?
- Frequent asset reconciliation against liability revaluations
- Pre-defined asset eligibility criteria
  - Tends to be constrained to liquid assets that the trustees could manage if ever returned to them
- "Pre-insolvency" surrender and other triggers

Institute and Faculty of Actuaries

Considerations For Trustees and their Advisers

- What are you trying to protect yourself from?
- What might cause this to happen?
- Would you really want your money back when the problem occurs?
- Would you lose FSCS coverage if you surrender the policy?
- If you have collateral are you aware your “pot” might underperform the larger “pot”?
- What does it cost and how likely is a claim – is this good value for money?
- Is “Additional Security” the wrong name for it – who wouldn’t want “increased Security”?

Institute and Faculty of Actuaries