Mission impossible

Tom Ground, head of bulk annuities and longevity insurance at Legal & General, explores why funding a buyout may be more affordable than thought, with the potential closure of a funding gap by 25%

Interest rates at record lows have caused funding deficits of UK pension schemes to balloon by over £100 billion over the course of 2014. This is despite billions[1] of pounds of contributions[2] being made by schemes to help lower the deficits. So given the current market conditions, an insurance de-risking buyout arrangement may currently not be viewed as an option for some schemes. However, for those schemes where they have already implemented liability-driven investment, (LDI) hedging strategies, this might not be the case.

Our recent survey[3] on the de-risking approach of large schemes indicates that almost two-thirds are planning to implement an insurance de-risking solution and half of these planned to do so in the next five years. The larger schemes are typically considering a number of different de-risking options to improve the funding level of their scheme. These options often relate to the assets these schemes are invested in, the quality of their data and the shape of benefits they are looking to insure. Bringing all of these factors together and considering them alongside an insurance solution, can drive efficiencies and accelerate the timeframe possible for UK pension schemes to still achieve a buyout in the current market.

The four key factors we believe schemes should consider, where collaboration with an insurer could potentially close a scheme's funding level by as much as 25% are as follows:

Factor 1. Committed funding

Schemes recovery plans and expenses typically fall upon the sponsor to meet and so can be seen as assets of the scheme. In total these assets could provide up to a **15% improvement in a schemes funding level.**

▪ **Recovery plans** – A report by The Pensions Regulator[4] indicated that the average schemes recovery plan term was 7.5 years and is on average 1.7% of the schemes liabilities, which are paid annually as deficit contributions. A deferred premium arrangement could allow a scheme existing recovery plan to be used to pay a proportion of the premium to an insurer – avoiding a larger upfront premium. So using The Pensions Regulator's figures, an average recovery plan could potentially be used to **improve the funding level of a scheme by up to 10%**. For sponsors, this means that contributions they are making to repair the pensions deficit will be fixed and are no longer open ended.

▪ **Expenses** – These do not typically feature in the trustees technical provisions but are a real and significant cost that will need to be met by the scheme's sponsor. The Pensions Regulator report showed that the average expense per member for a scheme with over 5,000 members was £182 pa[5]. If counted as an asset, then these expenses could represent a **5% increase in the funding level**. For smaller schemes, this figure could reasonably be even larger due to the reduced economies of scale they experience.

Factor 2. Demographics

Insurers closely guard their demographic assumptions as they are based on years of experience and data, which is unlikely to be available to other insurers or schemes. We find that the assumptions used by schemes are often over estimated, particularly by the very large schemes where there have been relatively few transactions on which estimates of insurer pricing can be made. Using the insurers more accurate assumptions could mean that **funding levels are improved by up to 1%.**

▪ **Longevity reinsurance** – While there are around seven primary insurers through which a scheme can complete a buyout in the UK, there are significantly more global reinsurers who actively seek to take UK longevity risk. Where reinsurance pricing is attractive, insurers often pass out the risk to the reinsurance market to provide better pricing to pension schemes - placing the risk where demand is highest can positively impact on the cost of the buyout. Insurers who have the capability to do this could secure an **improvement in funding by up to 0.5%**.

▪ **Member data** – Where insurers do not have data about individuals they make a prudent assumption about the scheme member(s). For example, not having information on member's postcodes or marital status. This will impact pricing but could also result in **an improvement in the funding level by 0.25%.**

Factor 3. Member benefits

The nature of the benefits to be insured have a large impact on buyout pricing **up to a 3% improvement in funding level** may be possible by reviewing the following aspects.

▪ **At-retirement options** – The new freedoms available to pensioners from April could potentially increase the attractiveness of various member option exercises. These could be incorporated into a bulk annuity policy to ensure members can

Key Factors for improving UK pension scheme funding levels	
Committed funding	Up to 15%
Demographics	Up to 1%
Member benefits	Up to 3%
Financial markets	Up to 6%
Total	**Up to 25%**

access their full range of options while potentially reducing the cost of insurance. Pension increase exchanges are a great example of how collaborating with an insurer could result in a cost saving on the insurance policy yet achieve a balanced deal for the trustees. These benefits arise where pension increases, which are difficult for the insurer to hedge, are replaced with increases where hedging is available, allowing the insurer to hold less capital against the transaction and so provide better pricing. This could result in **an improvement in the funding level for the scheme of up to 2.5%.**

▪ **Data cleansing** – Having data that has been cleansed can have two major benefits for a scheme. Firstly, clean data can provide an indication that a scheme is serious about buyout and lead insurers to dedicate more resource to a particular arrangement which may increase competition and deliver better pricing. Secondly, where trustees are seeking to obtain cover for residual risks, insurers will be more willing to provide this with greater comfort in the data supplied. However, we would always emphasise that data cleansing should never prevent a scheme from taking advantage of an attractive opportunity as it can always be dealt with as part of the 'true up premium', which reflects amendments due to changes in data after the bulk annuity policy has been put in place. Having clean data could **improve funding by 0.5%.**

Factor 4. Financial markets

While all the previous factors are important, getting the timing right when a scheme goes to market is an essential part of ensuring a successful process and could also result in improvements in a scheme's **funding level of up to 6%.**

▪ **Market timing** – Selecting the right time to insure is absolutely key. Over the course of 2014 we saw insurance pricing improve by around 2% relative to gilts, which was a great positive for schemes. Although what is key is that the difference between the worst and the best pricing points over that period was nearly 4%. So the time to complete the buyout arrangement could be the difference between the arrangement being affordable or not. Effective governance is essential to allow schemes to capture these opportunities and potential secure **improvement in funding of up to 4%.**

▪ **Illiquid investments** – Pricing for bulk annuity transactions is heavily influenced by the availability of illiquid assets, which allow insurers to offer better pricing to schemes – due to an illiquidity premium or ability to hedge unusual pension increases. The availability of these assets can be lumpy; so, as with market timing, being in a position to take advantage of opportunities in pricing can help a scheme insure at a lower cost and result in improvement **in funding levels of up to 1%.**

▪ **In-specie asset transfer** – Insurers often buy the same assets that the pension schemes already holds, typically long-term investment grade credit, such as corporate bonds. Where a scheme has these assets in place, an insurer might take these as payment for the premium and this saves the scheme the cost of selling the bonds or asset. Any charge included in the insurance premium, yet also potentially **improving funding levels by up to 1%.**

In summary

As explained, the combination of all the factors could help to close a scheme's buyout funding deficit by up to 25%, as outlined in the table below. So a scheme's buyout funding level could be significantly better than the trustee might expect. By early engagement with insurers schemes should be able to identify just how affordable a potential de-risking buyout could truly be, even in the current economic environment.

Written by Tom Ground, head of bulk annuities and longevity insurance at Legal & General

In association with

[1]http://www.pensionsage.com/pa/DB-deficits-increase-by-almost-100bn-in-2014.php
[2]The Purple Book, DB Pensions Universe Risk Profile, 2014, Pension Protection Fund and The Pensions Regulator
[3]De-risking journeys of large pension schemes, Legal & General and Engaged Investor, February 2014
[4]Scheme funding, Valuations and recovery plans of UK defined benefit and hybrid pension schemes, The Pensions Regulator, June 2013
[5]Defined benefit (DB scheme running cost research, The Pensions regulator, April 2014