In it for the long term

David Watt highlights some of the key points for pension schemes to consider when selecting an insurer for a buy-in or buyout

In selecting an insurer, price is an important factor for pension schemes, but price should not be the only factor and a low price may not always be the most meaningful consideration in the long term. Unlike the short-term insurance business (for example, motor and property insurance), where the consequences of under-pricing quickly manifest themselves, the repercussions for the pension buy-in and buyout business may not be realised for many years. This poses a challenge for pension schemes who are entrusting an insurer to meet the obligation to pay scheme members for the next 50 or more years.

One of the main benefits of buy-ins and buyouts is that the security of members' benefits naturally increases as they move out of the pension's framework into regulated insurance. However, not all insurance companies have the same financial strength and this should not be overlooked when selecting an insurer.

In the US, the 1991 insolvency of Executive Life, a California-based annuity writer, offers an interesting case study that ultimately led to a system under which pension plans cannot select insurers that have not first met independently-assessed 'safest available provider' criteria, irrespective of the price they can offer.

In the UK, a prudent regulatory framework exists to ensure that insurance companies remain strong, but no such specific requirement exists for buyout providers to be independently assessed against set criteria. To a large extent, pension schemes implicitly rely on rating agencies, the Prudential Regulatory Authority (the PRA) and any covenant advice that they take to assess and ensure the financial strength of insurers. The PRA is responsible for the regulation and supervision of insurance companies, while rating agencies consider various criteria in order to provide opinions on the financial strength of insurers in respect of their ability to pay claims to policyholders.

Regulatory capital coverage ratios and rating agency opinions are helpful to pension schemes in assessing the short-term financial strength of prospective buy-in and buyout providers, but what criteria might those schemes and their advisers use to form their own view?

Capital requirements

Insurers hold capital to ensure they can pay policyholders. Under the current regulatory capital regime (known as Solvency II), insurers are required to hold capital that reflects the risks they are exposed to, such that the insurer is 99.5 per cent certain of its ability to pay policyholders over the following year. In practice insurers hold a range of buffers above this requirement, making failure over the following year theoretically less likely than 0.5 per cent. Because it contemplates a one-year horizon, this measure can drive trustee and other decision makers' focus onto these shorter-term measures. Over the longer term, considerations, such as the quality, size and diversification of the insurer's balance sheet, are also important indicators.

Balance sheet quality, size and diversification

Insurers back the pension promises they take on with a variety of investments and must strike a balance between investing with caution and sourcing assets that generate yields sufficient to support competitive pricing. A large, established insurer with a high quality, well-diversified investment portfolio may in some instances charge a higher premium than those insurers that operate less diversified investment portfolios.

The benefit of diversification also extends beyond an insurer's investments. Mono-line insurers that focus on a specific product are exposed to a much narrower range of risks than multi-line insurers. Pension schemes therefore need to decide whether a higher premium represents good value for the additional security offered.

Long-term value

Whilst price will always be an important consideration, trustees and sponsoring companies should also pay close attention to the value of the policy they are buying. The long-term security of the insurer – demonstrated by a large and well diversified balance sheet – is an important and often overlooked point in that value consideration.

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