

# De-risking pension schemes through bulk annuity policies



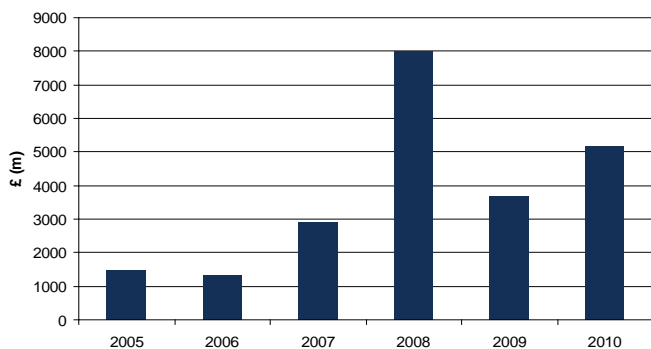
## A way out for your pension scheme - now is the right time to make a plan!

If you are running a defined benefit (DB) pension scheme, the chances are you would like a way out. Through their pension schemes, companies can find themselves the reluctant owners of significant annuity portfolios, with associated longevity and other risks, but why are they carrying these risks? After all, no company would choose to carry uncontrollable risks, such as longevity, elsewhere in its business.

For most companies with a DB scheme, only a small proportion of employees (if any) remain earning future benefits in the scheme, so the scheme becomes a legacy with associated risks. Trustees also need to reduce risk on behalf of members - securing annuities is part of achieving this.

There are compelling reasons to instigate a plan to reduce or eradicate a DB scheme over time and a bulk annuity is a valuable and cost-effective component to accelerate this. It is commonly a milestone on the way to eradicating pension scheme risk, but could mean the total removal of risk if the entire scheme is insured.

Bulk annuity market

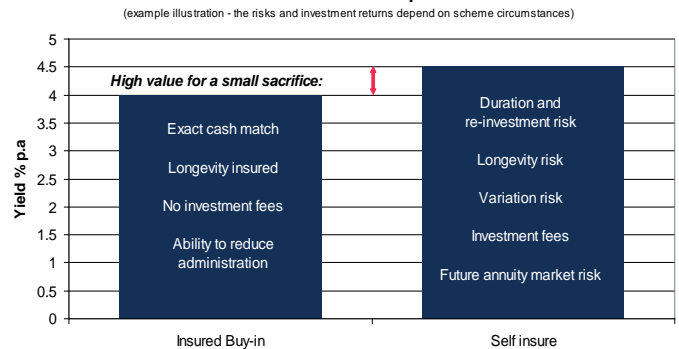


## The overwhelming case for buying annuities

The natural home for annuity portfolios is with insurers rather than companies. Insurers are best placed to assess and manage longevity risk and many reinsure the majority of the risk. Insurers can invest in much larger and more sophisticated asset mixes than all but the largest of pension schemes, which increases efficiency and they can administer schemes efficiently through economies of scale.

Securing a bulk annuity policy is the only way to de-risk a pension scheme in full. Prices for older members, such as pensioners, are particularly affordable for most schemes. This can be seen by comparing the investment returns normally achieved on the investments backing such members, against those achieved within a typical bulk annuity.

Pensioner bulk annuity  
Investment return comparison



Schemes often hold portfolios of Government and corporate bonds to best match the expected pension cashflows for their retired members. Depending on the mix of bonds, this can be expected to give an investment return of between 0% and 1% per annum above long term Government bond yields. A bulk annuity contract may yield close to, or just below, the long term Government bond yield. The chart shows a typical average difference of 0.5% per annum between the two rates. Furthermore, investment management fees may reduce this difference for the self-insured scheme. In addition, the self insured scheme will not match the cash flow perfectly: there will be some residual investment risk - in some cases substantial.

## Achieving major risk reduction

From the scheme and the sponsor's viewpoint, a bulk annuity policy will:

- Remove investment risk from the scheme, including duration (or "average term"), reinvestment and asset default risk.
- Remove all longevity risk.
- Remove the variation risk of largest annuitants living longest.
- Reduce or eliminate administration and consulting expenses

Funding, accounting risk and volatility will also be considerably reduced, which is good news for both the sponsor and the Trustees. Therefore, for a typically small reduction in investment yield there is a very major risk reduction. The equation is strong for a bulk annuity contract.

This risk reduction is valuable to scheme Trustees. They have to be mindful of their reliance on the long term future financial strength of the sponsoring employer for the payment of all future scheme benefits. A bulk annuity is a move towards reducing this reliance and associated risk. It is step towards an eventual scheme buy-out when the reliance will cease.

## Act now - opportunities may be limited

The current market is extremely competitive, with up to eight participating insurers at any given time. Different contract structures are available so that no immediate injection of cash is required if the sponsor and/or the scheme does not want, or is unable, to fund the deal in full from outset.

In addition to this competitive and flexible insurance market:

- Investment markets have been, in the main favourable for 2/3 years, which means affordability is as good as it has been since 2008.
- Insurers have reasonable mortality assumptions compared to assumptions adopted by most schemes - more reasonable than many may imagine and they have "sweet spots" which may mean very good value for certain schemes.
- There are uncertainties over future pricing in years ahead, specifically, the risks of Solvency II (and Solvency III) tightening and EEC equality judgements. Future increases in longevity assumptions - especially through medical treatment improvements.

A very important factor is the balance between supply (or capacity) of insurers to take on annuity business and the demand from pension schemes. This is currently well balanced but the rapid maturing of pension schemes means that most expect demand to rise significantly. It is not clear whether capacity will keep pace, if this does not happen it could lead to higher prices. In summary, although bulk annuity prices could rise or fall in how they relate to investment markets, most consider there to be a greater probability of rising prices. There is an opportunity now and delay may be costly. Therefore this is an excellent time to engage with the market (or re-engage if a quotation has been obtained before).

## Policy Flexibilities

If all members cannot be covered at one time the policy will include restructuring clauses to ensure the Trustees can treat all member categories equally in changing circumstances.

Payment terms can be flexible, some examples are as follows:

- Partly deferred payment - a scheme pays the share of fund for the affected members and the rest is funded via a recovery plan;
- Annual tranches, to be funded and transacted on guaranteed terms over a period of time;
- Deferred insurance - a scheme pays the share of fund for insurance at a point in the future consistent with the amount paid;
- "Future premium" contract - a scheme agrees a fixed sum to be paid in 10 years in exchange for insurance from day 1.

## Securing a buyout later may well mean a higher price

If a scheme has closed then it is moving towards a wind down - in the short, medium or long term. Unless it is run (with associated costs and management time) for decades until the final members and dependents retire and eventually die, there will be a time when benefits are insured in order to discharge benefit liabilities in order to facilitate a wind-up. This makes it a question of when, rather than if, insurance is sought. To run the scheme off in entirety involves further long term risk and cost.

The pertinent question is whether the time is right to insure some or all of the benefits, in conjunction with other liability management tools, appropriate investment strategy and data examination in order that a planned de-risking can take place. This is in the interests of trustees, sponsors and the members.

A bulk annuity may be secured later - but this may well be at a higher price. What are the investment and longevity risks being run in the meantime? Can these be reduced now?

If a scheme still has positive cash-flow due to the level of current contributions (and increasingly schemes do not) this does not address risk whatsoever.

## Enhanced security for members' benefits

Security of insurers is part of the assessment for a bulk annuity. Upon examination, trustees normally consider that security for members is enhanced.

## JLT Pension Capital Strategies - the clear choice

- This is a complex job and professional guidance is required. We specialise in de-risking solutions for pension schemes - it is the core of what we do.
- We know the market. This is evidenced by the body of research which we publish independently and our contributions to the industry press.
- We make deals happen. Our strike rate is significantly higher than most of our competitors. This is because we understand the market and can identify in the most suitable solutions for a given scheme.
- Our structure and pragmatic approach enables us to add value by completing exercises in an efficient and timely manner.

## Next Steps

For more information on how we might help, please contact Tiziana Perrella on 0161 242 5332, Colin Richardson on 0113 203 5913 or David Barratt on 01727 775421. Alternatively e-mail us at [solutions@pensionstrategies.co.uk](mailto:solutions@pensionstrategies.co.uk) or visit our website at [www.jltpcs.com](http://www.jltpcs.com) to register your interest.

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