

Buy-in: Q & A

We ask industry experts for their insight into buy-in

THE QUESTIONS

A: What groups of members are best suited to a buy-in and why?

B: What do trustees need to do in advance to help ensure a successful buy-in?



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TONY READ
MARKETING MANAGER
AEGON

A: Very few DB schemes are able to afford to go to full buy out. Even the recent recovery in equity markets, and consequent link to many schemes' fund values, are probably getting masked by corporate bond fields falling which have inflated liabilities. At the same time the desire for many finance directors to make some progress towards reducing their DB exposure is still there and so there is a conundrum – should they commit valuable capital at the present time assuming it's there in the first place or preserve capital and risk seeing buy out costs rise as people live longer and bond yields fall?

As often happens a solution has developed in the market and that is for schemes to undertake buy-ins for pensioners members. In this way there is still progress towards de-risking whilst at the same time not using up too much valuable capital at this time. Of course we are still seeing buy-in deals for deferred members but there has been a trend to pensioner deals for the reasons outlined.

“the scheme had bought out a group of members' benefits but this had never been recorded”

B: Apart from reviewing the price and other terms of the quotation before proceeding, in my view there three key things trustees can do in advance.

Firstly fully engage with the scheme's advisers to ensure that what the trustees are proposing to do fully fits in with a planned and structured de-risking strategy.

Secondly again in conjunction with scheme advisers look at the security of the life offices it is proposed to approach for quotes.

Thirdly ensure the scheme data is in good order and there are now a number of services out there able to do this including AEGON. This will enable the life office to quote as seen a price as possible – in one case we saw the scheme had actually bought out a complete group of members' benefits previously but this had never been recorded properly.



PAUL THORNTON
CHAIRMAN, PENSIONS ADVISORY
GAZELLE

A: Bulk annuity buy-ins are often seen in a “legacy” context, where they are used to prune the liability profile to reflect the current state of affairs – typically active membership having declined and the bulk of liabilities residing in deferred and pensioner membership. While movements in market conditions may make the cost of immunising one tranche of liability relatively better value than another on occasion, a bulk annuity contract is an investment of the scheme as a whole which is only notionally referenced to a particular group of members.

The buy-in should be seen as part of the scheme's overall de-risking strategy and the risk budget rather than selectively by reference to one group of members. Both sponsor and trustees need to ask what is it worth to immunise scheme funding risks? Buy-ins can represent good value, but are not costless. The insurance premium will build in the insurer's cost of regulatory capital and its profit margin, as well as the value which it is willing to ascribe to the scheme assets which forms all or part of the premium. There will also be asset transition costs and advisory costs.

B: Sponsors and trustees have in many cases been attracted by market conditions to investigate annuity buy-ins opportunistically. During the quotation process there will be a detailed assessment of risks and the how the insurer prices those risks against experience. This is the context in which data cleansing is often recommended well in advance.

This is fine as long as the groundwork has been done. Trustees and sponsors need to work together to assess and agree what they are trying to achieve through a buy-in. (For instance, does the sponsor perceive that its investors will value such a de-risking and, if so, does it have a view of the “price” which it would pay to achieve this; how would buy-in fit with the scheme's investment and LDI strategy?) Prior agreement on objectives, principles and strategy is critical to the success of any buy-in. A useful structure is a joint trustee-sponsor committee, working with its legal, actuarial, investment and financial advisory team to clearly defined objectives.



ANDREW STOKER
CHIEF ACTUARY
LUCIDA

A: Buy-in of pensioners usually appears more affordable to schemes than buy-in of deferred members due to the amount of capital that insurers have to hold against the latter.

Schemes may find that a sub-set of members appears better value because of differences in the assumptions used by the scheme and the assumptions used by the insurer (for example, if the scheme is more cautious on female mortality than the insurer then females will appear relatively better value). However insurers can be reluctant to insure sub-sets of lives and insuring only a subset of lives leaves the scheme exposed to the risk that the wrong members (ie, the uninsured members) live longer than expected.

Rather than insuring a subset of lives, the scheme could insure a proportion of every pensioner's benefits thereby obtaining partial protection against the longevity of every pensioner. This is the approach adopted in Lucida's recent transaction with the Merchant Navy Officers Pension Fund.

“ you could insure a proportion of every pensioner's benefits ”

B: One of the most important tasks when looking at a buy-in is to consider and set out your overall objectives. Trustees and sponsors need to understand whether this is a one off stand alone decision to de-risk an element of the scheme or whether it is part of a longer-term de-risking strategy. The overall objective will result in a different approach to the process.

To help ensure a successful buy-in, you must think about the state of the scheme rules, member data and the risks that you would like to transfer. Ideally, discretionary practices should be codified and data cleaned ahead of initiating a buy-in process. A buy-in contract will be in place for many years so relationships will be important. For this reason, we would encourage trustees to talk to buyout companies directly.

Considering these elements up front will prevent any surprises further down the line and will help smooth the path to a successful buy-in.



ANDY REED
DIRECTOR, DEFINED BENEFIT SOLUTIONS
PRUDENTIAL

A: Buy-ins provide trustees with an insurance policy that exactly matches the associated liabilities for pension payments (covering both mortality and investment risk). Therefore the most economic group of members to de-risk via buy-in is usually current pensioners, as the difference between technical reserves or accounting reserves and buy-in prices reduces as the age of the members increase. For deferred members, there is greater uncertainty of both future life expectancy and the actual level of benefits at retirement, often making buyout more expensive for deferred members compared with funding reserves. Therefore, alternative solutions (such as offering enhanced transfer values) may be more cost effective for de-risking deferred members' liabilities.

Buy-ins have typically involved large transactions covering all, or most, existing pensioners. However, for those trustees who cannot currently afford a large scale transaction, there are various ways to phase de-risking or to partially de-risk by targeting specific segments of liability exposure. Experienced providers such as Prudential can help trustees and their advisers to assess the scheme membership and identify any specific risk hot-spots.

B: The accuracy of membership data is vital. Conducting a thorough data cleansing exercise prior to engaging with buy-in providers helps identify any key risk areas and also ensures you receive accurate quotations. This helps avoid the time and cost required to obtain numerous re-quotes and reduces the possibility of actual costs being much higher than first assumed.

Recent volatile investment markets have also proven the importance of timing. Significant value can be lost through a protracted 'auction' process, due to adverse movements in financial markets, so delays (such as various rounds of re-quotes, involving numerous providers) can have a major impact. Having a clear de-risking strategy and an understanding of the type of credentials you are looking for in a provider can help avoid this.

Similarly the investment assets trustees hold are equally important. To enable a transaction to proceed when the timing is right, you need to ensure you are holding assets that are easily tradable, or better still, assets that an insurer will accept via an in-specie transfer. Leaving large scale disinvestments to the last minute has caused difficulties for some schemes.



MICHAEL CHATTERTON
HEAD OF SETTLEMENT SERVICES
WATSON WYATT

A: Pensions in payment are typically best suited to a buy-in because there is a lower exposure to longevity risk than for deferred members, leading to more competitive pricing for this member group. In addition, pensioner benefits are typically well defined with fewer uncertainties or member options to concern insurers with in their pricing. If the entitlements for sub-groups of the pensioner population (widows/widowers) are even better defined then terms can be even more competitive.

This does not mean that non-pensioners should be overlooked when trustees are looking to implement de-risking strategies like enhanced transfer value (ETV) exercises, for example, look to target non-pensioners and can result in an effective contribution to achieving overall scheme settlement goals.

B: The following steps should be taken in advance of implementing a buy-in transaction so that the full benefits are realised:

Data Data cleansing needs to be addressed when buy-in is first considered to allow enough time for a thorough investigation into the quality of the data. It is vital to ensure that the data held is 'fit for purpose' – the data fields that are focused on should yield the maximum economic benefit. A scheme-specific plan is built up by a data practitioner with detailed knowledge of plan design and administrative practices that will deliver maximum advantage. Typically, a cleaning plan will focus on spouses' contingent entitlements and 'hidden discretions' – where administrative practices have been established that do not mirror member entitlements under the scheme rules.

Investments Ensure that the scheme holds assets that an insurer would accept as an in-specie transfer or that are sufficiently liquid that they can be realised for cash to pay the buy-in premium

Trustee knowledge Bring trustees 'up-to-speed' on the rationale and process of carrying out such a transaction, via suitable training/information.

Whilst a buy-in is a trustee driven investment decision, it is important to ensure that the sponsor is prepared to fund any shortfall

Liability management exercises Consider exercises to help reduce the buy-in cost, for example the members could be encouraged to take transfers out of the scheme using an efficient ETV programme.