PENSION INSURANCE
CORPORATION

TAKING THE RISK OUT OF FINAL SALARY PENSION SCHEMES

Increases in life expectancy, falling bond yields and stock markets at levels of 15 years ago have created a perfect storm for many companies with final salary pension schemes, Joanne Christie finds

Increases in life expectancy, a prolonged period of low gilt yields and falling corporate bond yields have created a perform storm for many companies with final salary pension schemes. And while almost all have been transferring both new and existing members away from defined benefit schemes and towards defined contribution schemes for several years now, most are still struggling to match their scheme's assets with its liabilities.

Many pension scheme trustees, perhaps in partnership with finance directors, have so far looked to de-risk by reducing the risk profile of their assets. This might mean moving from equities to bonds and then to gilts. But the lower risk assets still don't provide a perfect match for the ultra long-term liabilities; a 45-year-old married member may not start drawing a pension till 2035 and this may continue to be paid until, say, 2060. Not many asset classes can guarantee an inflation-proofed income over that period. Uncertainty over future life expectancy compounds the issue.

These risks have a big impact on liabilities, which would largely explain the continued size of the aggregate deficit in UK DB pension schemes – £242bn at the end of April 2015, despite company deficit reduction contributions of £250bn over the past five years.

The ideal way to de-risk, of course, is to move the schemes off their books entirely. However, as companiess have made a promise to pay pension fund members their benefits for as long as they live and because legislation requires this promise be honoured, the only way they can do this is to transfer the commitment to an insurance company.

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Insurers such as specialist Pension Insurance Corporation (PIC) will take over a company's defined benefit scheme obligation, either in its entirety through a buy-out, or in stages through buy-ins. A buy-out transfers the entire liability of a pension scheme to an insurance company and the scheme is wound up. Members are then given a policy by the insurer that states that it will provide the benefits promised. The company has no further involvement, obligation or risk exposure.

A buy-in is similar, but applies only to a specific, pre-determined, tranche of pension scheme members, typically the retired members or a portion of them. The pension scheme remains in place and the insurer provides a stream of income to the trustees. This removes all the risks associated with paying pensions from that stream of income.

Insurers are regulated ultimately by the Bank of England and have to hold significant solvency capital over and above the value of liabilities. This ensures safety and security for members but in turn, an insurer will assess what amount of assets they would require to be transferred to them to accept the liability. This will be greater than the liabilities stated in the company accounts and also typically higher than the scheme's technical provisions.

£242bn
aggregate deficit in UK DB pension schemes

£14bn
total value of pension scheme de-risking transactions last year

These types of de-risking options are becoming increasingly popular with large listed companies, Jay Shah, head of origination at PIC, told a group of finance directors at the recent ICAEW Finance Director Conference.

"This is becoming more routine and more established and the sort of thing that the largest listed companies are looking at," Shah told delegates at a breakout session entitled DB pension buy-ins and buy-outs.

Last year the value of such transactions totalled about £14bn, and while currently this represents a yearly transfer of only about 1% per year of the total liabilities of final salary pensions in the UK's private sector, Shah said interest is growing among those in charge of pension funds.

But while companies are keener than ever to get pension liabilities off their balance sheet, many cannot afford to do so via a full buy-out due to the amount of assets required by insurance companies to take over the liabilities.

Shah said that while most companies' balance sheets show a deficit between the assets and the liabilities of a defined benefit pension scheme, most underestimate the gap between the two.

"We tend to find that most pension schemes are still understating life expectancy. There has been a huge catch-up over the last few years but I would still expect it to be more than people are estimating," he explained.

He said insurers are also typically more conservative than companies in their estimates of net present value and investment risk, so the value they put on a company's liabilities can be higher than the company's view, depending on how well they have been advised.

While Shah said the gap varies by pension scheme, there's no doubt there is often a significant gap to fill. However, companies have a strong motivation to find ways to do so, he said, particularly during times of corporate activity such as merging with another company, spinning off a subsidiary or closing down an operation.

"We've tracked the positive reaction of the market in terms of the share price for quoted companies on the day they made an announcement around de-risking their pension scheme, either with a buy-in or buy-out," he explained. "The market is already factoring a much higher level of liabilities than what is published in the annual report, a recent study by Llewellyn Consulting put that figure at around 20% higher, which feeds directly into the share price. The one thing that investors are worried about is uncertainty."

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With the weight of pension fund liabilities hanging over the shares of many listed companies, Shah said most pension scheme sponsors' ultimate aim is a de-risking plan that involves a full buy-out. In the meantime, however, many of those that can't afford to fund the gap between their own estimate of liabilities and an insurer's are opting for a partial solution via a buy-in.

For example, last year PIC, which accounts for about one quarter of the buy-in/buy-out market, undertook a buy-in worth £1.6m for energy operator Total, PIC's largest deal and the second-largest buy-in transaction to date. PIC took over responsibility for all the retired members of Total's defined benefit scheme.

"This is a good example of a partial solution," said Shah. "You are not tackling the whole scheme in one go, you are tackling a part of it."

Many companies start the process of transferring away risk with members of their schemes who are already retired as there is less divergence in the views between companies and insurers of the risk attached to these members for two main reasons: their age means there is less time for their life expectancy to change; and the assets held against pensioner liabilities are usually low risk.

In the case of the £500m buy-in PIC did with Cadbury in 2009, the food company transferred only half of its pensioner members. Shah predicts that as companies find the deficits in their pension schemes narrowing, they will increasingly look to buy-outs or buy-ins as they seek to move away from their defined benefit schemes. Buy-ins will remain more popular in the meantime

"Every survey you look at around companies and trustees' views on where they want to go with a pension scheme will tend to talk about a journey plan, or a de-risking plan, that ultimately involves a full buy-out. It might be over the next 12 months, it might be over 12 years but directionally most pension scheme sponsors are saying 'this is where we want to go'."