



Getting your scheme buyout ready

Trustee Solutions Limited and JLT Employee Benefits

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Why buyout ready?

Defined benefit is dying

For many years we have heard how defined benefits are dying out – before long the offer of a final salary pension will become a thing of the past. Even the Government's proposals around defined ambition are unlikely to breathe life back into defined benefits. The Office for National Statistics has recorded a dramatic decline in the number of members still building up defined benefits: the number more than halved from 4.6 million in 2000 to 1.6 million in 2013. The Purple Book 2014 tells a similar story: only 13% of defined benefit schemes are still open to new joiners, down from 31% in 2008. Closed schemes are on the rise, with 32% allowing no further build-up of pensions, up from 17% in 2008.

However, for employers sponsoring defined benefit schemes and trustees tasked with managing them, the defined benefit headache is far from over. Legacy defined benefit liabilities in the UK amount to over £1 trillion (closer to £2 trillion on some measures¹) and the decision by an employer to move away from defined benefit provision is only the start of a very long process in terminating any liability in respect of the benefits promised. This process can be a frustrating drain on resources and a considerable risk on the sponsor's balance sheet for a benefit that is no longer part of their recruitment and retention strategy.

Sponsors of closed defined benefit schemes essentially face two choices: to continue to run the scheme off until the last pensioner dies or to secure the benefits promised in full with an insurance company (which is a requirement of current legislation in order for the scheme to benefit from the tax relief available). The strategic direction for the pension scheme is clear and it is effectively in palliative care – it is not so much if it will terminate, but when.

Which way to go?

Run-off can be expensive. There are a number of costs that are incurred by trustees in the day-to-day running of a scheme: actuarial and administration costs; investment-related expenses; fees for audit work, legal advice, covenant reviews and trusteeship; and the PPF levy, not to mention all the management time spent considering pension issues. Typically, the costs of running a pension scheme are up to around 2% per annum² of the value of scheme assets, with larger schemes best able to benefit from economies of scale. This is before any contributions by the sponsor to repair deficits in the scheme, which can increase dramatically if funding levels deteriorate between valuations. There are also costs involved in the preparation of the sponsor's accounts.

Alternatively, the scheme benefits could be secured with annuities. Buying annuities is not like shopping for groceries – in the current economic climate most schemes are in deficit and the assets are simply not sufficient to cover the cost of the liabilities. Even if the sponsors could stump up some cash and make up the balance, there are two potential challenges to overcome.

Firstly, money. In many cases, the extra funding required is significant. Even if extra funding is available, the cost of annuities relative to the funding of the scheme is very sensitive and timing the market is crucial to ensure the best possible deal. This is a market-specific issue, over which trustees have little control.

Secondly, information. Insurance companies do not actually take the place of the trustees of the scheme. An insurance company will pay the benefits requested by the trustees to the beneficiaries identified by the trustees. Trustees need to be certain that the benefits have been described accurately and all the beneficiaries have been identified. In older and more complicated schemes, neither of these requirements is as simple as it sounds.

In practice, there will come a point where a scheme shrinks to a size where the fixed overheads of running it become disproportionately expensive and the only sensible decision is to secure the remaining benefits with an insurance company. It is not uncommon for schemes to get to a fully insured position in incremental steps – progressively securing sections of the benefits as and when this is affordable (via partial buy-ins), usually starting with the benefits in payment to some or all of the current pensioners. The comments in this guide apply equally to 'buy-ins' and 'buyouts' (see glossary).

Buyout ready

Over the first half of 2012, annuity pricing became much more affordable for many schemes. So much so that the extra funding needed to secure the liabilities for pensioners, especially older pensioners, was minimal for these schemes. Despite this improvement on the money challenge, this market opportunity was not taken advantage of by many since most schemes either failed to spot it or their information was not up to the standard needed for buyout purposes. An opportunity lost for inexpensive de-risking.

In order for schemes to take advantage of future market opportunities, trustees and scheme sponsors need to ensure that the scheme-specific information issues are all resolved and that everything within their control is 'buyout ready'.

What follows is a review of those issues that are within the control of the trustees and sponsor and which, once resolved, will ensure the scheme is primed, buyout ready and able to capitalise on future market opportunities. The three areas addressed are: member data; promised benefits; and investments. We also take a quick look at the buyout market and the process trustees typically go through to secure an annuity.

Member data

The Pensions Regulator issued guidance in June 2010 on record keeping, aimed at improving data standards across the industry. It set out a proposed framework for data checking, in particular for 'common' and 'conditional' data (see glossary). However, the data requirements of insurers are a little more demanding.

Missing data

Whilst it is important that trustees ensure their common and conditional data is in order, they should not stop here if they want their scheme to be buyout ready. When pricing a buy-in or buyout, insurers will make prudent assumptions about any missing data items. The most common include:

- Marital status and spouses' existence
- Spouses' dates of birth
- Postcodes.

¹ The Purple Book 2014, Pension Protection Fund & The Pensions Regulator

² JLT Employee Benefits

With a little effort, it is possible for trustees to source and verify this data using tracing services that are both reasonably priced and non-invasive. Doing so could materially lower prices by cutting insurers' margins for prudence, although in a small number of cases it could increase the cost (for example if spouses are found to be much younger than members). Regular member existence checks are also important. Tracing and verification can take time and are worth undertaking earlier rather than later to prevent them acting as barriers to transacting a deal quickly, at a good price when an opportunity presents itself.

Poor quality data

Poor data quality can not only affect buyout prices; in some cases it can put insurers off quoting at all. The other danger is that trustees secure a mismatched bulk annuity policy due to inaccurate member records, which can then cause headaches a few years down the line when they have to correct benefits before they can wind-up the scheme.

To be buyout ready it pays for trustees to collect and correct data now and keep it up-to-date. If trustees are to take advantage of market opportunities, data quality must be maintained.

Guaranteed minimum pensions (GMPs)

Certain schemes (that were previously 'contracted out') have some guaranteed benefits, GMPs, that are effectively a replacement for earnings-related State pension benefits. For many schemes, particularly those with fairly high average pensions, the GMPs form a small part of total scheme benefits. Even so, they require careful treatment. Trustees need to verify their GMP records with those held by HMRC before the ending of contracting out in April 2016. This can be complex and time-consuming, so is best not delayed. HMRC are offering a new Scheme Reconciliation Service to help cope with increased demand.

The other complication is that European sex discrimination legislation technically requires GMPs to be equalised between men and women. At the time of writing, there is no definitive guidance from the Government on the method to be used to achieve this. For the time being, only schemes trying to fully secure all benefits and wind-up are taking any action to equalise GMPs – insurers generally expect them to have made their best endeavours to do this using a method deemed reasonable by the scheme actuary and the scheme's legal adviser.

Promised benefits

It is easy to think that the benefits provided by a pension scheme are clear and unambiguous, but reality can be somewhat different. Some schemes have a single benefit basis that has hardly changed over the years, with minimal impact from legislation. However, most schemes do not fit this simple model.

Benefits under the rules

A review of the promised benefits will result in a full benefit specification setting out definitively what each member is entitled to under the scheme rules. Such an exercise will often reveal issues where the administration of the scheme in the past has not reflected the correct entitlements. Particular problems have arisen with equalisation, for example where the scheme has equalised retirement ages incorrectly and further work is required to put this right. In some cases, normal pension age is misstated for some

members and changes have to be made and often backdated. It is important to iron out these issues at an early stage.

Matching scheme benefits

The format of the benefits payable under a pension scheme may present challenges to insurers both in terms of administrative complexity and in finding suitable assets within the insurers' own investment portfolios to be able to match the types of risk taken on (and hence offer keen pricing). In practice, these can all be addressed through careful planning and viable, cost-effective solutions can usually be found. We illustrate a few examples below.

Feature	Issue	Possible solution
Pension payment and increase dates	Complex to administer if pensions are paid monthly from date of retirement and/or increases are awarded on anniversary of retirement. This leads to many different payment/increase dates across the scheme membership.	Aligning pension payment and increase dates prior to heading to buyout can simplify the administration of the benefits, which may be reflected in a reduced premium.
CPI-linked pension increases	A market for CPI-linked investments is in the very early stages of development. Many insurers therefore struggle to find assets to match CPI-linked benefits, leading to higher premiums than anticipated given that CPI is expected to be lower than RPI over most periods.	Schemes could insure RPI-linked increases today, with an option to switch to CPI-linked increases in future once a market in CPI-linked investments is better established.
High fixed pension increases or floors to inflation-linked increases	Certain types of pension increases are difficult for insurers to replicate in their wider investment strategies and hence can be more expensive to insure. Examples include: (a) fixed 5% p.a. pension increases; or (b) RPI min 3% p.a. max 5% p.a. pension increases.	In the short term it could be more cost effective not to insure the exact scheme benefits, i.e. retain some risk within the scheme, but with an option to switch to the exact benefits at the point of wind-up. For example: (a) insure non-increasing pensions; or (b) take out the floor and insure RPI max 5% p.a. increases. Alternatively, members' benefits could be re-shaped through a pension increase exchange exercise.

Investments

As well as checking all the data issues and ensuring a full appreciation of the promised benefits, trustees also need to give due consideration to the asset side of the equation, in particular:

- Price movements on the bulk annuity quotation compared to scheme investment performance in the period leading up to the transaction
- Liquidity
- The mechanics of paying the premium to the insurer.

Matching annuity pricing

The way in which a buyout or a buy-in operates means that the final premium to be paid is not usually known until the settlement date – the date the payment is actually made. Typically, how this works is that a price is agreed based on market conditions at an earlier date and this price is then rolled forward in line with daily returns calculated using a formula specified in the annuity contract – this can be based on a reference portfolio or on specified indices.

To reduce the risk of the price increasing by more than the scheme assets over this period (or falling by less), trustees should ensure that assets to be used in the transaction are invested in asset types that provide a reasonable 'match' for annuity prices, in other words, assets which change in value in a similar way to the change in annuity prices. Examples could include corporate or government bonds.

For premium payment purposes, trustees should avoid holding volatile assets such as equities, which are not a good match for annuity prices and have the potential to fall in value quite rapidly. If this fall happens immediately prior to a transaction, this could make the deal unaffordable.

Liquidity

Similarly, trustees should review the liquidity and marketability of their assets to ensure they are able to settle the bulk annuity premium within the timescales agreed with the insurer. In practice the importance of this will depend on the transaction mechanism.

Paying the premium

Rather than requiring the premium to be paid in cash, some insurers are prepared to accept some or all of the scheme assets for the transaction in settlement. This is called an 'in specie' transfer. This can be more cost effective since trustees would otherwise incur the transaction costs of disinvesting into cash, and an insurer would include a loading in their premium for the costs of investing the cash received into suitable assets within its wider portfolio.

Insurers will not accept just any assets. The type of assets that they are willing to take in specie will depend on their internal investment strategy, risk limits and capital adequacy requirements.

For larger transactions, if the trustees are holding assets that would not be acceptable in specie by the insurer, then they should balance up the cost and complexity of switching into acceptable assets (which could also reduce mismatch risk over the period to premium payment) or undertaking a part cash, part in specie transfer (with the in specie reflecting those assets that the insurer deems desirable), with the cost of realising investments and then settling the premium in cash.

The trustees should take appropriate investment advice on the asset transfer/premium payment mechanics.

The buyout market

The buyout market has grown significantly over the past few years as the appetite to de-risk pension schemes has steadily increased. To match this demand, the number of providers has also increased and there are significantly more players today compared to eight years ago. This market place can currently support transactions for almost any size of scheme. The market offers competitive prices, with innovative solutions available from insurers aiming to differentiate themselves through their flexibility and products on offer.

The Chancellor's March 2014 Budget announcements, which introduced radical changes to how consumers can choose to use their pension funds at retirement, have had a knock-on effect on the buyout market. Providers who sell individual as well as bulk annuities have seen new business volumes for the former fall dramatically, which has in turn increased their appetite for buy-ins and buyouts. New market entrants are also anticipated towards the end of 2014 or early in 2015, as these too seek to replace lost individual annuity business.

Medical underwriting

A recent development for transactions involving 300 or less pensioners has been the growth of a market in medically underwritten bulk annuities, in which information on members' health is used to obtain bulk annuity prices that more accurately reflect a scheme's expected longevity. Up until this development, bulk annuities have been priced based on each member's age, sex, postcode and pension size, without reference to their individual health or lifestyle. Underwriting removes some longevity uncertainty for insurers and allows for more granularity in their pricing.

This innovation is likely to be suitable for schemes where the trustees believe the membership to be in worse than average health or where there is a high concentration of mortality risk (for example, a few lives make up a high proportion of the liabilities). There has been some research³ to suggest that with judicious medical underwriting an underwritten bulk annuity could offer schemes savings of up to about 10% relative to the cost of a conventional policy. In some cases, this could make a transaction more affordable and attractive.

³ A Healthier Way to De-Risk, Cass Business School & Pensions Institute

Trustees should beware, however, that once they have obtained medical data, they are obliged to share information connected with this activity with insurers. This will preclude them from obtaining quotations from some insurers who cannot offer an underwritten quotation. Also, it may be that a conventional approach would have offered a more competitive price, for example if members are of better than average health.

Market monitoring

Once trustees and scheme sponsors have the scheme information buyout ready, they should ensure they keep their finger on the pulse of the bulk annuity market.

Many employee benefit consultancies are able to conduct feasibility studies, using sample rates supplied by insurers on a regular basis to gauge the potential for a transaction to go ahead. This is often much cheaper and quicker than going to the market for indicative quotations. Some consultancies also offer monitoring services, to track scheme assets and liabilities against proxy buyout prices. Pre-agreed trigger points allow trustees to identify and act on opportunities to transact at an affordable price.

However, it is not enough just to monitor prices. History has shown that at times of favourable pricing and extreme demand (for example in 2008), insurers have been unable to respond to all quotation requests received from schemes eager to transact. Preparing quotations costs insurers time and money – according to some estimates between £5,000 and £10,000 per quote. In times of extreme demand, insurers will focus resources on those cases that are most likely to transact and represent the best allocation of capital. Other schemes will either be disappointed or may be charged for quotations.

The Purple Book 2014 identifies around £1.7 trillion of buyout liabilities as at 31 March 2014. Of this around £440 billion relates to schemes with fewer than 5,000 members. This compares to buyout transaction volumes of up to £8 billion a year over the last

eight years⁴. Even if there is currently spare capacity in the market, this highlights future problems if these liabilities are to be insured within any reasonable timescale – there is only so much capacity unless new insurance solutions and/or new market players emerge.

We would challenge the idea that trustees will always be able to transact a buy-in or a buyout when market conditions are favourable – they may struggle even to get a quotation. In practice those that are buyout ready and working with an adviser with strong insurer relations and a proven track record for getting deals done should be at the front of the queue.

Securing an annuity

The process for securing a bulk annuity is broadly as follows:

- Approach suitable insurers on an anonymous basis to see if they are prepared to provide a quotation
- Provide insurers with the scheme-specific information (i.e. benefit specification and full set of current data)
- Insurers issue indicative quotations for the cost of providing the specified benefits
- Trustees review the indicative quotations and may decide to proceed with a few insurers with the best premiums
- The (shortlisted) insurers provide guaranteed quotations (usually valid only for a few weeks). Note: only the calculation basis is secured – the price will fluctuate with market movements
- The trustees review the guaranteed quotations (with advisers), and if they accept a quotation, the corresponding policy is signed and the trustees arrange for the premium to be settled in line with the terms of the contract; usually within five business days. The insurer is now on risk for any changes in membership (such as deaths and retirements)
- The data is confirmed, any wrinkles removed, and a balancing payment is calculated and paid. The policy is now fully implemented.

⁴ 2014 Annual Buyout Market Watch, JLT Employee Benefits

Glossary of terms

Term	Meaning
Annuity	A series of payments, which may be subject to increases, made at stated intervals until a particular event occurs. This event is most commonly the end of a specified period or the death of the person receiving the annuity.
Bulk annuity	A buyout or buy-in policy under which the benefits of a number of members are secured with an insurer through the purchase of annuity policies. This compares to an individual annuity which only covers one member.
Buy-in	The purchase by the trustees of an occupational pension scheme of an insurance policy that matches some part of members' accrued benefits. The policy is purchased in the name of the trustees and so remains an asset of the scheme.
Buyout	The purchase by the trustees of an occupational pension scheme of an insurance policy in the name of the member or other beneficiary. This is in lieu of entitlement to benefits from the scheme and means that the policy is not an asset of the scheme.
Capital adequacy	Capital requirements that govern the ratio of equity to debt that can be held by a financial institution.
Common data	Data items required to uniquely identify a member.
Conditional data	Data required for the effective administration of a scheme.
In specie	Where physical assets are transferred to the insurer rather than selling assets and settling the transaction in cash.
Medical underwriting	An analysis of the longevity risk inherent in providing an insurance policy based on information gathered on a member's health or lifestyle. If a member is deemed to be in worse than average health then an annuity may be offered on enhanced terms or vice versa.
Pension increase exchange	An offer to exchange the pension increases promised under the pension scheme rules for a higher initial pension but with lower increases.

How to contact us



Robert Lawrence
Senior Associate
Trustee Solutions Limited
T: +44 (0)113 225 5425
E: robert.lawrence@trusteesolutions.co.uk



John Kempster
Pensions Trustee Manager
Trustee Solutions Limited
T: +44 (0)121 260 4015
E: john.kempster@trusteesolutions.co.uk

Trustee Solutions Limited
30 Crown Place
London EC2A 4ES



Martyn Phillips
Director
Buyout Team
JLT Employee Benefits
M: +44 (0)7796 998140
E: martyn_phillips@jltgroup.com



Ruth Ward
Senior Consultant
Buyout Team
JLT Employee Benefits
T: +44 (0)20 7558 3036
E: ruth_ward@jltgroup.com

JLT Employee Benefits
The St Botolph Building
138 Houndsditch
London EC3A 7AW



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Authorised and regulated by the Financial Conduct Authority. A member of the Jardine Lloyd Thompson Group.
Registered Office: The St Botolph Building, 138 Houndsditch, London EC3A 7AW.
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Trustee Solutions Limited

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A list of Directors is available for inspection at the Company's Registered Office 1 Park Row Leeds LS1 5AB
Company Registered in England No 2698755

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