Endgame for defined benefit pension schemes: buy-in and buy-out

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Endgame for pensions

- Background on charity sector pensions
- Pensions business case
- What’s happening now
- Takeaways

Background on charity sector pension deficits

Source – Charity Commission https://charitycommission.blog.gov.uk/2020/12/11/lets-be-clearer-about-the-risk-of-a-pension-scheme-deficit/

Charities reporting a pensions deficit up from 740 in 2012 to 1,219 in 2018.

Sample of 100 charities reporting a pensions deficit had combined pensions deficit of £557.4m.

Most were handling this risk appropriately.

Most charities did not report the matter in enough detail in their annual accounts and trustees' annual report.

58% of charities from a random sample did not explain, in the trustees' annual report, the impact of the pension deficit on their financial position.

Example pension schemes

British Red Cross pension schemes' valuations depending on the basis of calculation:

- Accounting valuation 2021 - £15.8m surplus
- Actuarial valuation 2019 - £7.9m surplus
- **Buy-out valuation – deficit / surplus**?

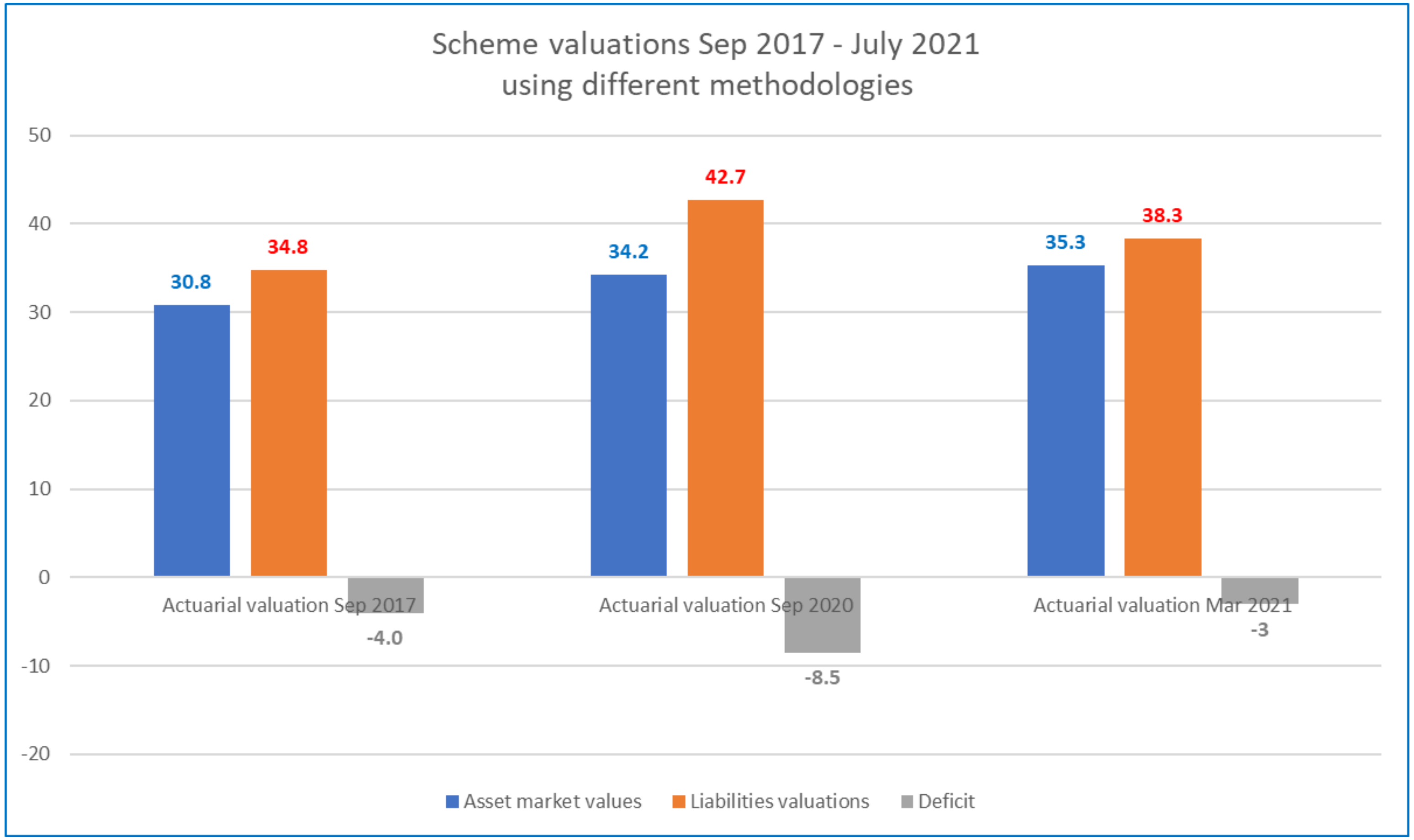
RNIB main pension scheme's valuations depending on the basis of calculation:

- Accounting valuation 2021 - £42.1m net asset
- Actuarial valuation 2020 - £33.3m deficit
- **Buy-out valuation – deficit / surplus?**

Pensions business case

Information
1. Scheme valuations
2. Buy-out – explanation
3. Buy-out quotes
Cost-benefit
Changes in valuations

1. **Scheme valuations -** The IS defined benefit pension scheme is subject to volatility. The IS faces significant risks and additional costs as a result of the volatility.



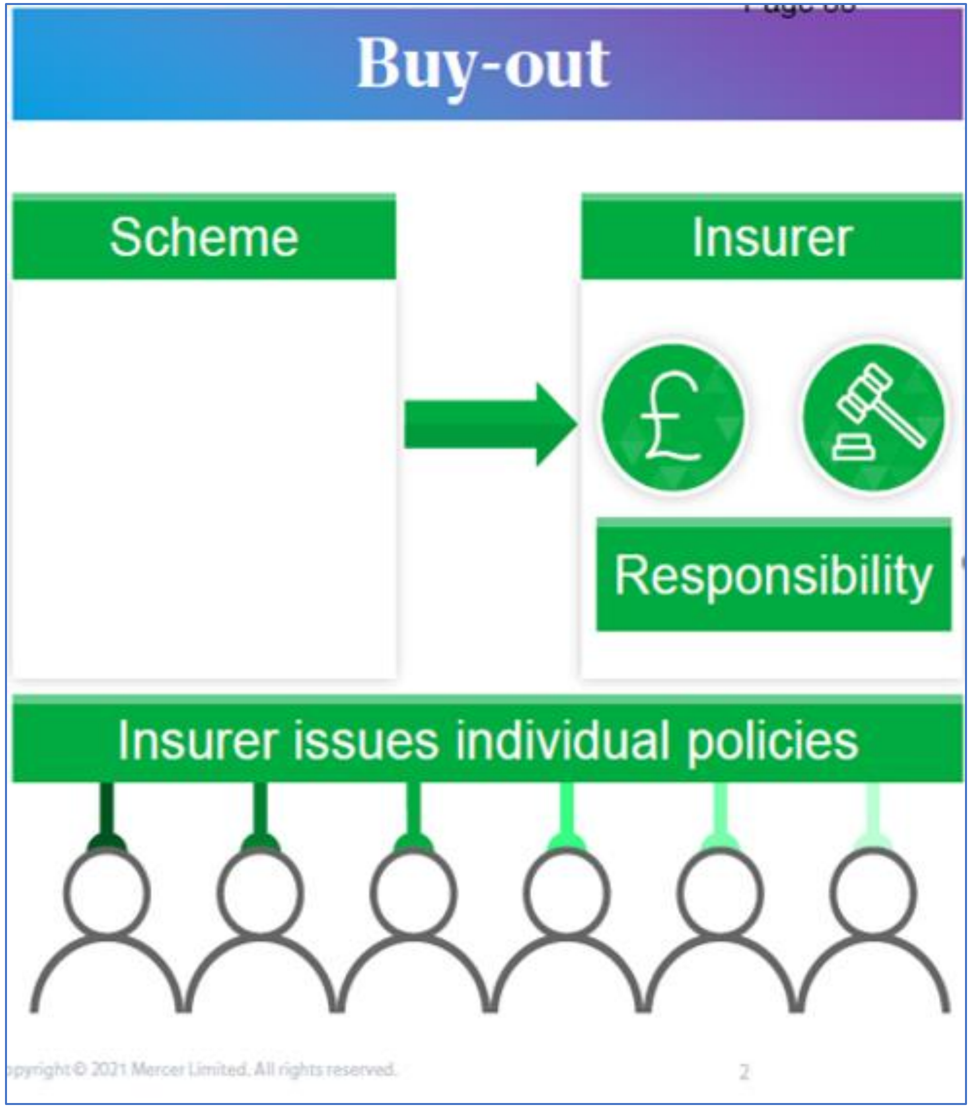
Background

Pension schemes are subject to volatility both in asset values and the calculation of liabilities. The IS as employer is legally obliged to settle the pension fund deficit.

At the triennial valuation in 2017, the deficit on the IS pension scheme was £4.0m. The IS paid an additional £4.0m into the scheme in 2018-2020.

However, at the most recent triennial valuation as at September 2020, the deficit had risen to £8.5m due to an increase in the liabilities. Fortunately, by March 2021, the deficit had reduced to £3.0m due to a reduction in the liabilities and an increase in asset values.

2. Buy-out: The long-term aim for defined benefit pension schemes is to achieve a buy-out. Buy-out sees the scheme wound down and its assets and liabilities transferred to an insurer who takes full responsibility for the pension fund. The employer then no longer bears financial risks for a pension scheme.



WHAT IS A BUY-OUT?

A buy-out is the final stage of the de-risking journey when the trustees pass all legal responsibility for administration, payments and communication for the members selected to an insurance company. It's normal for all members to be covered so trustees can wind-up the scheme, but it's possible to arrange a buy-out for a sub-set of the membership, in which case all groups of members must continue to be fairly treated.

All benefits payable under the scheme rules must be covered or the scheme rules altered to assist the buy-out. This means that normally the first stage of a buy-out is for an insurance company to issue a buy-in policy for any benefits and/or members not already covered by existing buy-in policies.

Next, the insurance company issues individual annuity policies to the pensioners and deferred pensioners covered, and they become their policyholders. The insurance company guarantees to pay an income stream directly to each member selected that is an exact match to the full pension benefits they're entitled to receive. This is known as a buy-out, and if all members of the scheme are covered the trustees can then wind-up the scheme.

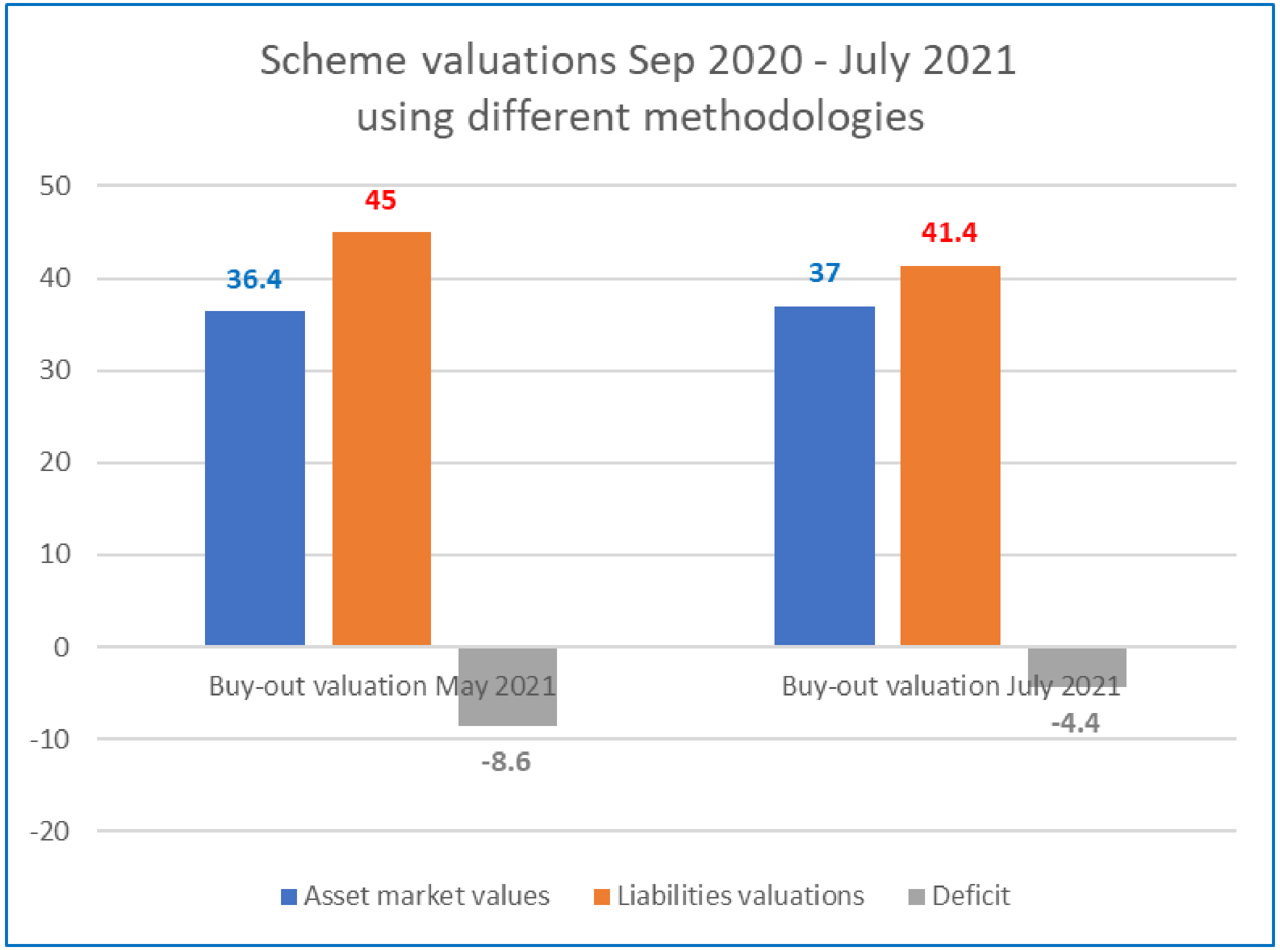
WHAT ARE THE KEY STAGES OF A BUY-OUT?

1. Scheme trustees make a single premium payment to insurance company
2. All responsibility for the scheme and members transfers to Insurance company
3. Insurance company issues individual annuity policies to members and they become policyholders of the insurance company
4. Insurance company pays pensioners directly and issues any communications required to them and their dependants

Buy-in

Buy-in: The Defined Benefit scheme pays an insurer a fixed fee upfront to assume responsibility for some of the scheme’s pension liabilities. The scheme retains the obligation to its members and makes benefit payments that are reimbursed by the insurer.

3.1 Buy-out premiums - history: With the improvement in the funding position of the IS pension scheme, we sought quotes for a buy-out. The quotes received as at May 2021 was for a buy-out premium of up to £8.6m. By July 2021, the quote had improved to £4.4m



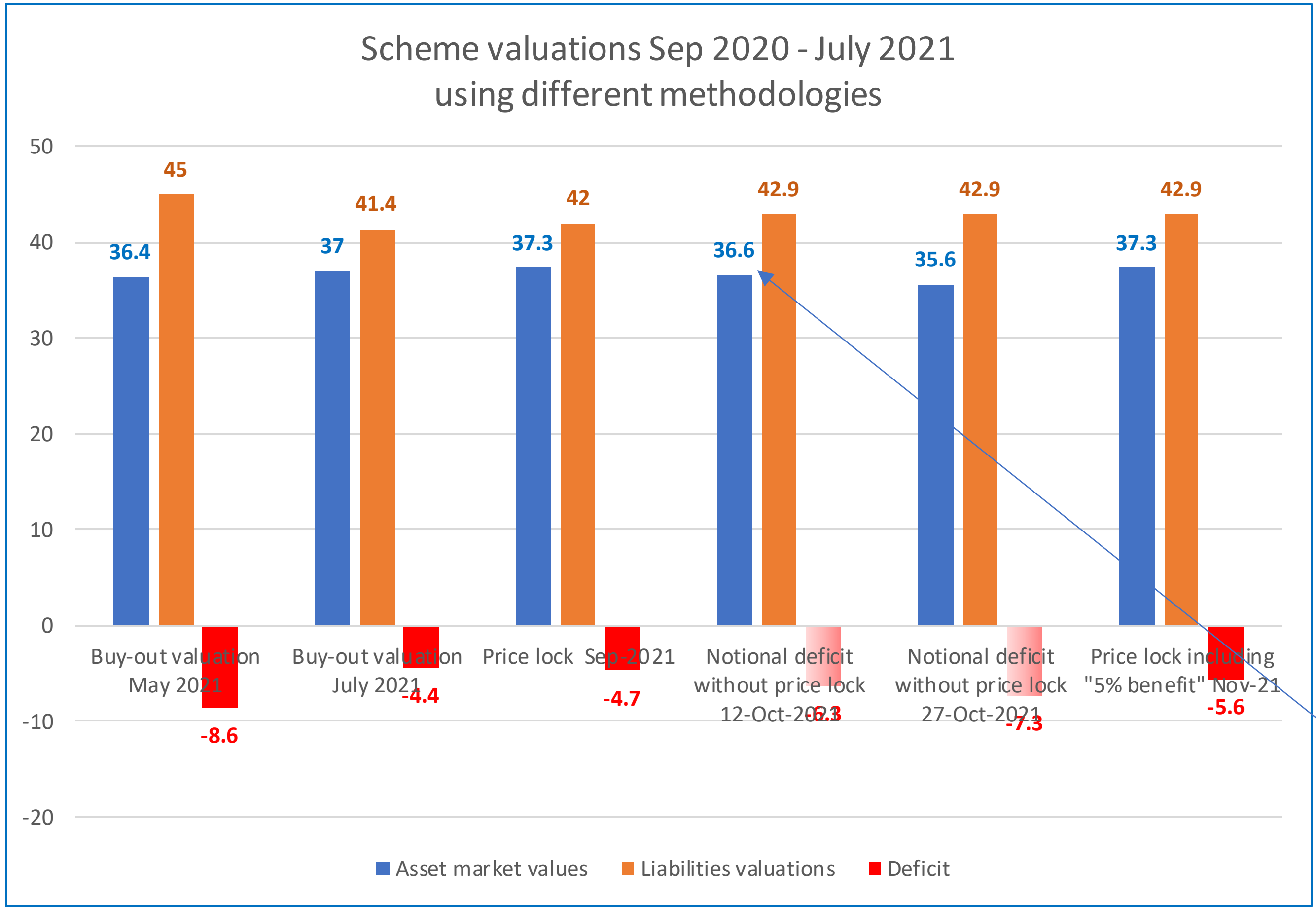
Background:
Two companies, provided quotes for a buy-out. The buy-out valuation has a higher deficit than an actuarial valuation. While the assumptions for calculating liabilities are similar, the insurer also includes additional amounts to cover risks, costs and their margins.

In spite of the premium, a buy-out can be good value for an employer as an insurance company has economies of scale for professional fees, administration and managing investment risk of assets and the volatility of liabilities.

Updated formal quotes as at July 2021 from company A had improved to a buy-out premium of £4.4m while Company B's quote had worsened to close to £9m. Company A's quote is time limited to six weeks hence the urgency in receiving a decision in principle from the board.

Quote is time limited and subject to being updated in line with market conditions. Quotes were sought from other providers who all declined to quote either because the scheme was too small or because they had too much work on in 2021.

3.2 Buyout premiums update: Following the initial buyout premiums of £8.6m and £4.4m, the preferred provider gave a price lock in September for £4.7m. In November, the buyout premium was increased to £5.6m after insurer updated their calculations based on a more detailed understanding of the scheme benefits.



Background:

As part of the normal buy-out process, the pension scheme lawyer identified differences between the benefits offered by the insurer with the benefits set out in the scheme rules. Most of these differences did not lead to a material change in the buyout premium.

Beware of anomalies

The Amnesty scheme provides an exceptional benefit to 28 deferred members of a fixed 5% annual increase in benefits. Insurer had used the standard assumption for increase in benefits of RPI capped at 5%. The 5% increase had been set following arbitration by independent counsel following a dispute with scheme members.

[Since September, market values of assets fell by £0.7m and then a further £1.0m. This could have taken the buyout premium up to £6.3m and £7.3m respectively. However, with the price lock, insurer has taken on the asset risk]

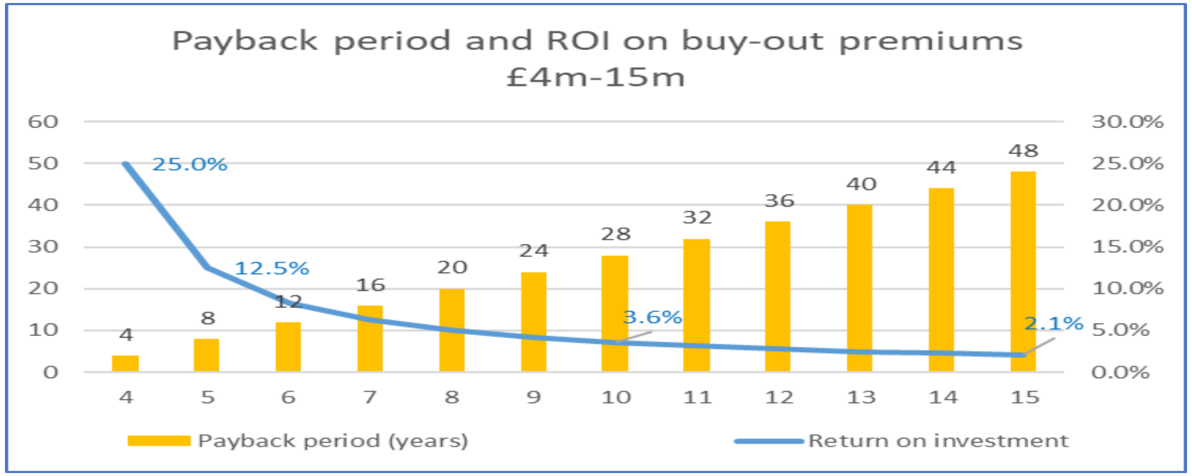
4. Cost-benefit of a buy-out: The return on investment for the buy-out transaction:

- was 18% pa in July 2021 with an estimated buyout premium of £4.4m (£1.4m above the funding deficit) was 18%pa and payback period was six years.
- is 10% pa in November 2021 with the price lock and updated assumptions, and premium of £5.6m (£2.6m above funding deficit), payback 10 years.

There is also a significant benefit from de-risking the pension scheme and not facing significantly higher costs in the future.

N.B. Recent legislation on GMP (Guaranteed Minimum Pension) will increase the funding deficit by an estimated c£0.9m. The IS will be required to pay this amount (yet to be calculated) whether or not the buy-out goes ahead so it does not alter the business case but needs to be factored into IS cash flow forecasts. There is a two-year period for data cleansing so the reduction in fees will be delayed by two years.

		Sep 2021 price lock	July 2021 valuation	May 2021 valuation
Buy-out premium £m		**5.6**	**4.4**	**8.6**
Funding deficit £m		3	3	3
Buy-out premium less funding deficit £m [A-B]		2.6	1.4	5.6
Annual cost savings £m		0.25	0.25	0.25
Payback period (years)	[C/D]	10.4	5.6	22.4
Return on investment	[D/C]	9.6%	17.9%	4.5%



Cost benefit details

The annual administrative cost of the scheme, excluding staff time, is in the range £260k to £310k. After a buy-out of the defined benefit scheme, some fees would still be incurred for governance of the remaining defined contribution scheme. The annual saving is likely to be c£250k.

If a buy-out was transacted at a premium of £4.4m, then the IS faces an additional cost of £1.4m, over and above the £3.0m that the IS is already obliged to pay to settle the funding deficit. The payback period is under 6 years i.e. £1.4m / £0.25m = 5.6 years. The return on investment would be 18%.

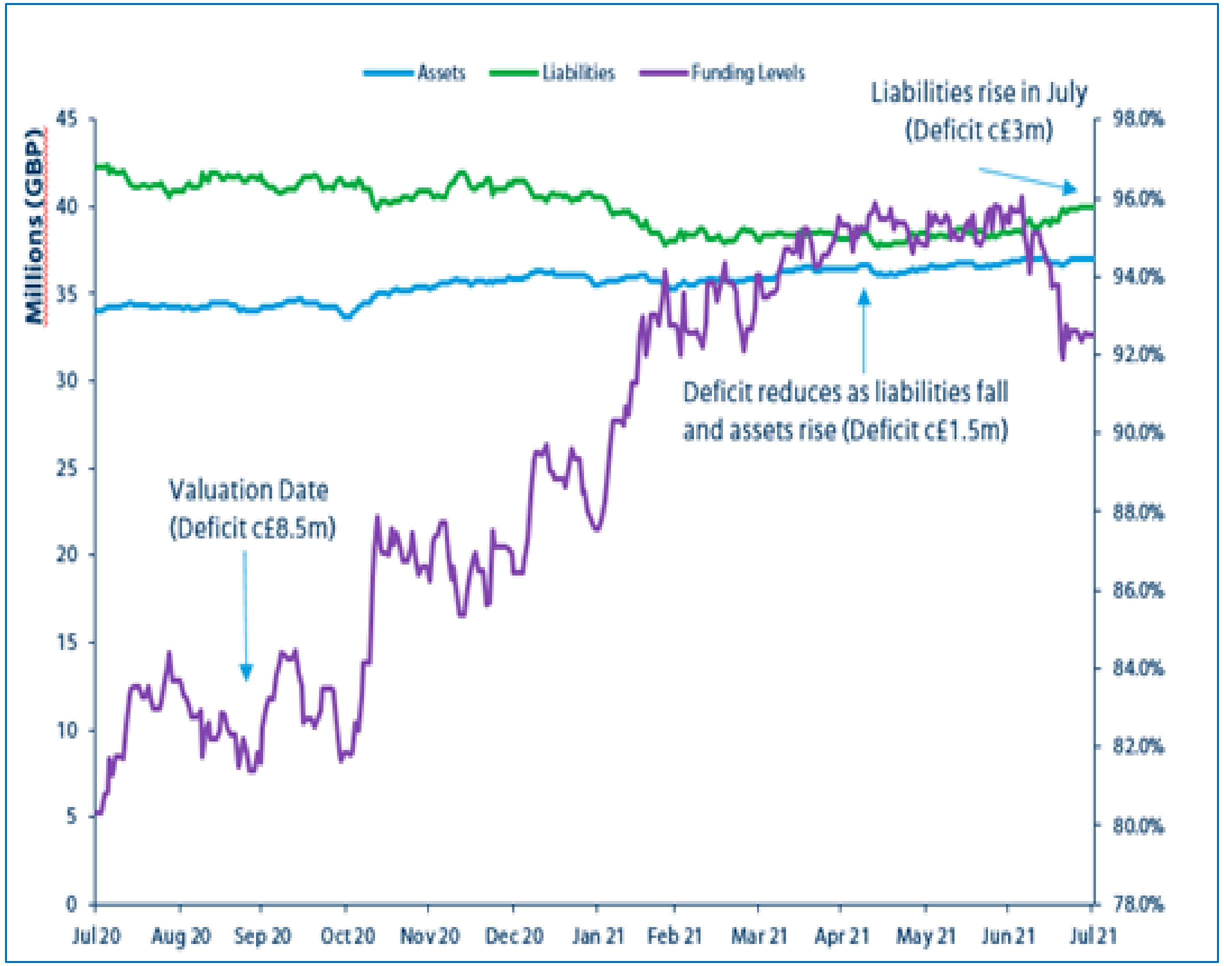
If the buy-out premium was £8.6m, then the pay back period would be 22 years, with an ROI of 4.5%.

Even at £10m buy-out premium, the ROI at 3.6% is not unreasonable. The payback period jumps to 28 years. However, it is harder to justify spending the quantum of £10m from reserves, particularly as there is a greater likelihood that the position could improve.

[Sensitivity analysis - If the annual saving assumption was £200k:

- *£4.4m buy-out premium, payback period increases to 7 years and ROI reduces to 14%*
- *£8.6m premium, payback period increases to 43 years and ROI drops to 2%]*

5. Changes in valuations driven by volatility of valuation of both assets and liabilities



Asset Volatility

The assets are mix of growth assets such as equities and stabilising assets such as government gilts and corporate bonds. 70% invested in growth assets are expected to give a higher long term return than the stabilising assets although these higher returns come at the cost of increased volatility.

World equity markets fell around March 2020 when COVID first hit.

Recovery in equities at the valuation date of 30 September 2020 but most of the recovery occurred after the valuation date.

Stabilising assets are mainly government gilt values but these were also volatile.

In March 2020, the value of gilts increased and so schemes with a higher proportion of gilts saw increasing values. Increase in government gilt values means lower return on gilts as you receive same fixed income you get from a gilt.

Liability Volatility

Liabilities = pension payments to members for the rest of their lives and possibly a pension to a surviving spouse.

Value of liabilities = present value on pension payment (i.e. cashflows with a discount rate)

Assumptions are in the Statement of Funding Principles:

- The higher the discount rate the lower the value placed on the liabilities.
- Discount rate is linked to the yield on government gilts.
- Yields fell in March 2020 the discount rate fell so value of the liabilities increased, then yields rose to June 2021, and then fell again in July 2021.

What’s happening now?

Post-transaction project plan - November 2021 to November 2023:

- Data cleansing
- GMP equalisation (Guaranteed Minimum Pension) calculations and additional £1m+ liabilities
- Other checks: AVCs – Additional Voluntary Contributions
- Trustee indemnity

Take-aways

- Defined benefit pension schemes are the gift that keeps taking
- Multiple stages in approval process
- No surprises
- Simplify so everyone understands what’s happening
- Create a pathway now