LET'S TALK

JLT EMPLOYEE BENEFITS SEPTEMBER 2014

BULK ANNUITY INVESTMENTS – SHOULD WE WAIT FOR INTEREST RATES TO RISE?

THE PERENNIAL QUESTION

Trustees, sponsors and consultants alike frequently ask bulk annuity specialists "is now a *good time* to buy-in/buyout?" With long-term interest rates only partially recovered from recent historic lows, and real yields (i.e. inflation-adjusted interest rates) still negative (see Chart 1), a common follow up is "shouldn't we wait for interest rates to return to more *normal* levels?"

Whilst the circumstances of every UK defined benefit pension scheme are different, this article aims to dispel common misconceptions and examine the rationale for immediate action. Our counter question to trustees and sponsors is "if you have the ability to buy-in, buyout or otherwise de-risk your investment strategy today, can you really afford to wait?"

WILL THE POSITION IMPROVE IF INTEREST RATES RISE?

What's important to realise is that the buy-in or buyout position for a pension scheme is the combination of two or more moving parts. The buy-in/buyout premium by itself is fairly meaningless (except as a measure of the sponsor's absolute exposure to the scheme), so is typically compared to one or more of the following:

- The Technical Provisions – the trustees' assessment of the monies required today to meet the scheme's liabilities now and in the future.
- The realisable value of the scheme's assets.
- The accounting liabilities – the figure the sponsor reports for the scheme in its corporate accounts.

In different scenarios some of these will become more or less relevant. For a full scheme buyout, the difference between the buyout premium and the scheme asset value is of most interest and additional contributions may be required to bridge any gap. In contrast, for a pensioner only buy-in the trustees will typically focus on the gap between the buy-in premium and the Technical Provisions and ask the sponsor to make this good, effectively restoring the scheme's funding level to its pre buy-in position. The sponsor will be concerned about the impact of a potential buy-in/buyout on its corporate balance sheet and profit and loss account, as well as any additional funding it may be asked to contribute.

A rise in interest rates will affect each of the above measures to a different extent; hence the relevant gap may get bigger or smaller, even if buy-in/buyout premiums reduce in absolute terms.

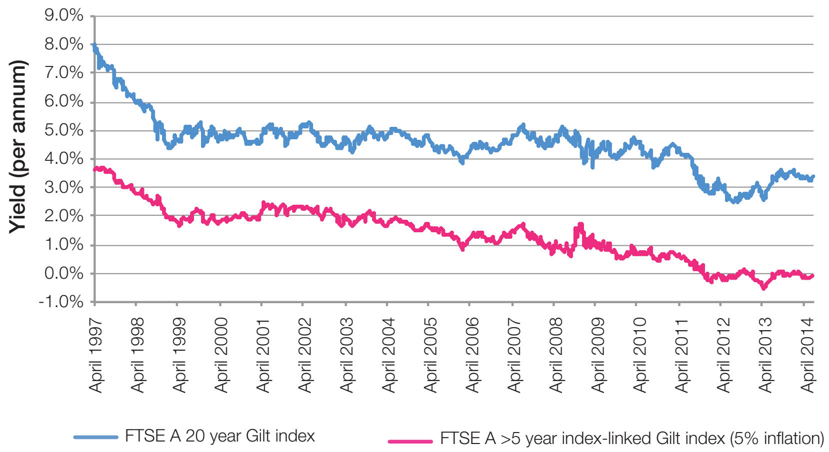

Chart 1: Historical long-term nominal and real Gilt yields (Source: Thomson Reuters)

WHAT COULD THE IMPACT ON PREMIUMS BE?

Most UK defined benefit pension schemes will pay out pensions every year for at least the next 20 years and in many cases much, much longer. When insurers calculate their premiums they need to work out how much money to ask for today to be as certain as they can be that they'll have sufficient reserves to pay the agreed pensions until the last insured member dies. To calculate this they look at interest rates over the entire 'yield curve' (i.e. the interest rate that would apply if one were to borrow over 1 year, 2 years, 3 years etc.), and use these to work out how much money they need to hold to pay pensions due in each future year.

The yield curve already reflects the market's current expectation for the level of interest rates both now and in the future. We illustrate this as follows.

Chart 2 shows the Gilt (i.e. UK government bond) yield curve as at 30 June 2014. Note that the yield at the 1 year maturity is around 0.6% p.a. but over 2 years it is around 1.0% p.a. So the implied interest rate between 1 and 2 years must be higher than 1.0% p.a. – in fact the market expects to have to pay around 1.4%-1.5% p.a. to borrow for 1 year in 1 year's time. Using similar principles we can sketch what the market expects the yield curve to look like in 1 year's time (called a '1-year forward curve').

When pricing bulk annuity contracts today using the current yield curve, insurers are implicitly recognising that the market expects interest rates at all maturities to be higher in 1 year's time. In other words, they have priced in the market's current expectations for future interest rate rises. Therefore, there might only be an advantage in waiting for interest rates to rise if it turned out that the market had significantly underestimated the amount by which interest rates would rise or the timing of this. Under such a strategy, you would effectively be betting against the market and would run the risk of other factors moving against you, as we go on to explore.

Let's suppose the market was right and interest rates were higher in 1 year's time (as per Chart 2). Then, all else being equal (and assuming interest accrued precisely offsets benefit payments over this period), bulk annuity premiums would be expected to be lower than they are today. But all else is never equal! There are many other financial factors that influence insurers' premiums, for example many insurers invest in corporate bonds so movements in credit spreads (the difference between yields on corporate and government bonds) will influence pricing, as will expectations for future inflation rates. Adverse movements in these could offset any benefits derived from rising interest rates. Moreover, this is expected under certain scenarios.

For example, at times of improving economic outlook we would generally expect interest rates to rise and credit spreads to get narrower (since corporate debt would be expected to become less risky). Hence although higher interest rates would be expected to lead to lower annuity prices, this effect might be offset by narrower credit spreads. Chart 3 shows the historical relationship between long-term corporate bond and Gilt yields and the spread between these.

WHAT ABOUT THE IMPACT ON SCHEME ASSETS AND LIABILITIES?

The market values of fixed or index-linked bond-type assets (e.g. corporate or government bonds) will reflect the market's expectations for future changes in interest rates (and inflation); hence, as above, expected interest rate movements are already built into current valuations.

Schemes often hold bond-type assets to notionally back their pensioner liabilities. If interest rates rise (and other factors remain unchanged) then annuity premiums may fall, but so too will the value of the bond-type assets that would potentially be used to fund a pensioner buy-in (as well as the trustees' assessment of the pensioner liabilities). So, is the scheme actually any better off?

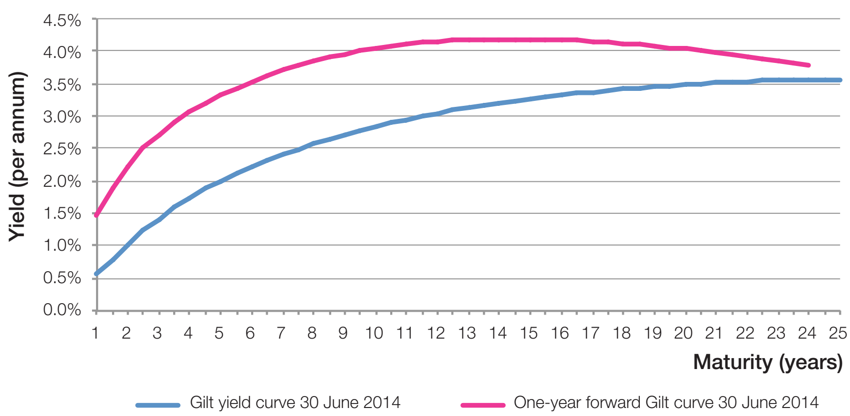

Chart 2: Current and one-year forward Gilt yield curves as at 30 June 2014 (Source: Bank of England, JLT)

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The scheme might also hold growth-type assets (e.g. equities or property). Historically, rising equity prices have been associated with falling bond prices (i.e. rising bond yields/interest rates), although as with any economic trend there are always exceptions. A key risk for trustees and sponsors is the reverse scenario. In the recent recession, we experienced both falling equity values and interest rates – a double hit for most pension schemes! However, strong equity market recoveries over 2013 and H1 2014 combined with the above comments on interest rate trends mean that movements in scheme asset values are likely to have outperformed buy-in/buyout pricing for many schemes, potentially making a transaction more affordable.

Ultimately the extent to which premiums and scheme asset values move together will be determined by how well the scheme assets match both the scheme's liability profile and the insurers' own investment portfolios. Some trustees opt for intentionally mismatched strategies to try and gain from unexpected interest rate rises (or equity market rallies). Such strategies leave schemes exposed to falling interest rates and growth asset values and trustees should take appropriate advice on whether the sponsor could make good any resulting funding level deterioration before embarking on this type of risky strategy.

WHAT ABOUT THE LIABILITIES?

The assumptions that trustees use to assess their scheme's Technical Provisions (or funding liabilities) can vary significantly from those that insurance companies will make when evaluating the same liabilities for pricing purposes. There are many reasons for this, but the immediate consequence is that the gap between the Technical Provisions and insurance premiums may vary substantially over time and, in particular, could widen even at times when premiums more generally are falling.

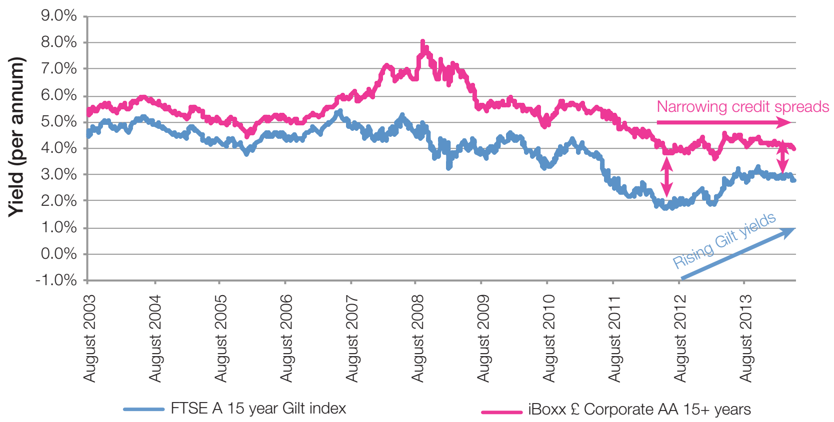

Chart 3: Historical long-term nominal and real Gilt yields (Source: Thomson Reuters)

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WHAT ELSE DRIVES INSURER PRICING?

There are many other factors in addition to interest rates and other financial factors that affect market pricing of bulk annuities. These include:

- Longevity trends – the rate of improvement in the length of time that scheme members are expected to live for.
- Insurer appetite – how keen insurers are to complete a buy-in/buyout transaction for one or more schemes.
- Solvency capital requirements – the amount of money insurers are required to hold as a contingency against adverse future events.

The trend has been for some of these to strengthen (i.e. increase insurance premiums) over time, for example increasing life expectancies and more stringent capital requirements (with a new European-wide supervisory regime – Solvency II – due to be introduced in 2016).

Insurer appetite is influenced by many different internal and external drivers. In our recent Let's Talk describing the impact of the March 2014 Budget announcements on the bulk annuity market, we commented that insurer appetite has increased recently following a reduction in the volume of individual annuity business being written. Other drivers include insurers' progress against their internal new business targets (which are typically measured on a calendar year basis) and the relative attractiveness of a scheme, in particular:

- Whether action has been taken to source missing data.
- How clean the data is.
- Whether the sponsor is committed to meet any additional contributions required.
- How likely they believe the scheme is to transact – some insurers may charge for quotations if they are not convinced a deal will go ahead.

In our experience, insurers are becoming more selective about the schemes they will quote on so it is becoming more important to have undertaken preparatory work before approaching the market.

WHAT IF I WAIT?

There could be a time in the future when buying a bulk annuity looks more attractive than it does today, but there are two main problems with waiting for this to come around:

Firstly, since many pension schemes follow similar investment strategies, a 'good time' for your scheme to buy-in/buyout is likely to be a 'good time' for lots of other schemes. 2008 was one such example – credit spreads widened dramatically, reducing the corporate balance sheet impact of transacting a buy-in/buyout. At such times, demand for bulk annuity quotations can significantly outstrip insurers' ability to produce them. Hence, there is no guarantee that trustees will even be able to get a quotation, let alone transact a buy-in. For example, in 2008 one particular insurer turned down around 90% of quotation requests received.

Secondly, there can be a few weeks' lead in time to a bulk annuity transaction – it generally takes 2 to 4 weeks to prepare the necessary data and around 6 to 8 weeks to get initial quotations. So even if the trustees/sponsor spotted a good opportunity and insurers were willing to quote, the opportunity might have passed by the time they were able to transact if their scheme wasn't ready to trade. Well prepared schemes that have already assessed affordability and have a firm commitment to trade will always be at an advantage.

We are aware of plenty of cases where schemes have been ready to complete a buy-in or buyout but have delayed in the expectation of an improvement in pricing which has just not materialised.

WHAT SHOULD I DO NEXT?

Trustees and sponsors should consider whether to insure their liabilities as soon as they can afford to do so. There is no guarantee that the position will look better in future and, even if it does, it may prove more difficult to get a quotation and execute a transaction. In practice this is likely to mean that most trustees insure their schemes' pensioner liabilities (or subsets of these) in the first instance, and cover more members at a later date.

To help you understand whether a transaction is affordable, JLT can do a quick initial assessment using up-to-date annuity rates from insurers to estimate the range of current market pricing for your scheme and compare this against your funding liabilities. This will allow you to make better informed decisions about the feasibility of a transaction.

Even if a transaction does not appear immediately affordable, we will highlight options that may help. These could include deferring payment of part of the insurance premium, undertaking medical underwriting or insuring just part of the membership where pricing looks most attractive. There is a significant amount of innovation and flexibility available in the de-risking market and JLT can assist you in designing an appropriate solution if a transaction is not immediately affordable.

If none of these work, we would still recommend you spend some time getting your scheme 'buyout ready' and monitoring the buy-in/buyout position. Buyout is the end game for the majority of pension schemes so reconciling guaranteed minimum pensions, tracing missing data and compiling a

ABOUT US

JLT Employee Benefits is one of the UK's leading employee benefit providers offering a wide range of benefit and pension services, including administration, actuarial and pension consultancy, investment, Self Invested Personal Pensions (SIPPs) and Small Self Administered Schemes (SSASs) administration, flexible benefits, healthcare, benefit communication and financial education.

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comprehensive summary of scheme benefits with legal sign-off will all help to secure a quotation in the future and make sure you are not at the back of the queue when you want to transact.

WHERE CAN I GET HELP?

Your usual JLT contact can refer you to our dedicated Buyout Team. Alternatively email buyouts@jltgroup.com.

The JLT Buyout Team completed 30 bulk annuity deals for our clients over 2013, over 15% of total market deals transacted last year. Our deal conversion rate, measured at c. 60% by one leading insurer in a period up to July 2013, is significantly ahead of the industry average (which regular market speculation and commentary put at around 20%). The Team are able to advise on a wide range of transaction types, varying in size from below £1m to in excess of £1bn, covering deal structures from conventional bulk purchase annuities to fully bespoke de-risking solutions.

Please get in touch.

This Let's Talk does not constitute advice.