LET'S TALK

JLT EMPLOYEE BENEFITS SEPTEMBER 2014

FLEXIBLE PAYMENT TERMS – MAKING BUYOUTS A REALITY

IS BUYOUT A FAR AWAY DREAM?

The majority of trustees of closed UK defined benefit pension schemes should have a long-term aspiration to buyout scheme benefits with an insurer, securing members' pensions against future underfunding risks and the possibility of sponsor insolvency. Many sponsors share this dream, anxious to avoid unexpected future funding calls and uncertainty on their corporate balance sheets.

For most, however, buying out benefits in the short term has seemed little more than a pipe dream, with expected costs prohibitively high and the gap between scheme assets and buyout premiums unable to be bridged from current resources.

Now, two factors are helping to make this dream a reality: recovering funding levels and increased flexibility in the type of solution insurers are willing to offer. If anything, the latter has only increased since the Chancellor's March 2014 Budget announcements (see our earlier Let's Talk: Budget 2014).

WHAT TYPE OF SOLUTION ARE INSURERS OFFERING?

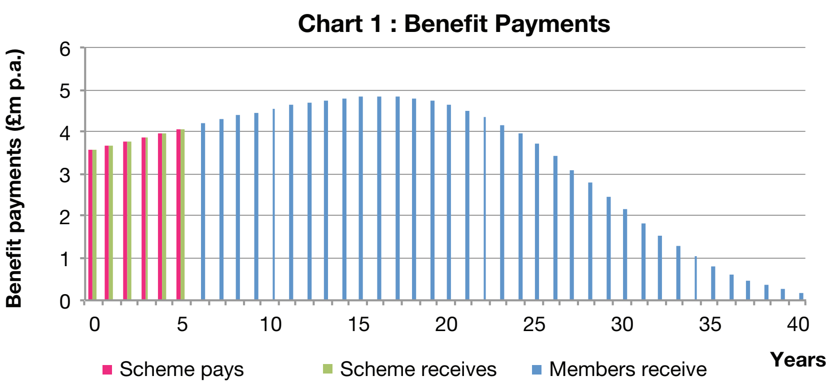
For schemes that want to buyout today but can't cover the full premium immediately, insurers are offering structured payment terms to help them stagger the payments. This is often referred to as a 'deferred premium structure'. In essence, the scheme benefits are fully covered on day one, with part of the premium (say 70%) paid immediately and the remainder spread over an agreed recovery period (of say 2-5 years).

The sponsor pays interest on recovery payments, in the same way as it would on a bank loan. The loan terms typically look favourable as they are essentially those the insurer themselves would get, i.e. those for an A/AA-rated entity. The insurer generally mitigates their counterparty exposure to the sponsor by reserving the right to scale back insured benefits, as a last resort, if the sponsor defaults on its payments.

Under such an arrangement, the sponsor swaps an uninsured scheme with an uncertain funding level and potential for increased future contributions (e.g. if assets perform worse than expected), for an insured scheme with a known set of payments needed to discharge their liability to members. The triennial scheme funding valuation is often an ideal time to consider such a solution and hence derive greater certainty over cash commitments, although in practice it could be considered at any time.

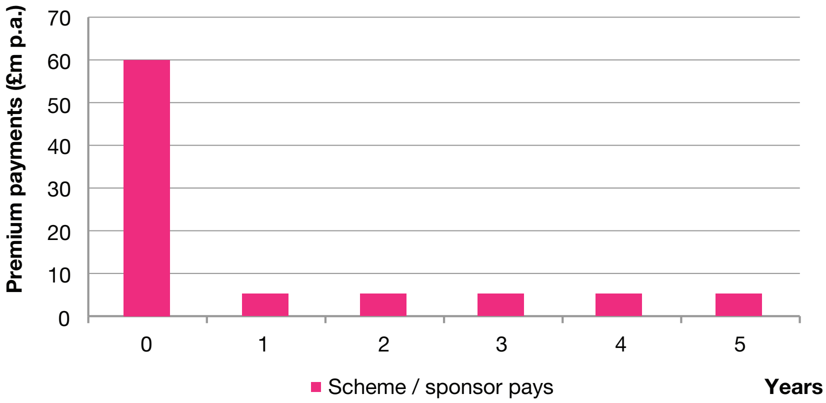
Illustrative example

Chart 1: Insurer matches benefit payments from scheme until full premium is paid off, after which individual policies are issued and members are paid directly by insurer.



Source: JLT Employee Benefits

Chart 2 : Premium Payments



Source: JLT Employee Benefits

Chart 2: 70% of full premium paid upfront, with remaining premium plus interest spread over following five years, at which point all risks are fully covered.

HOW WOULD IT WORK IN PRACTICE?

The exact structure and terms would be agreed with the insurer, but one example is as follows:

- The trustees sign one contract in respect of the benefits covered by the initial, partial premium payment, which most insurers would insist were at least equal to the level of benefits provided by the Pension Protection Fund (PPF)
- The trustees sign a second contract which covers the remaining benefits up to the full level provided by the scheme, together with a mechanism for paying the recovery payments plus interest and scaling back the benefits covered in the event of sponsor default.

An alternative structure offered by some insurers is to secure a deferred bulk annuity policy commencing in a few years' time, say six years from now. The trustees and sponsor would therefore ensure that, at the point this came into effect, all liabilities were covered, and could focus on meeting pension payments (and other cash payments, e.g. transfer values) in the intervening period. This structure would leave them with some risk over the period until policy inception, but would remove longer term investment and mortality risks.

Chart 3 : Benefit Payments

Source: JLT Employee Benefits

Chart 3: Scheme/sponsor pays 70% of full premium (not shown above) plus the first six years of benefit payments, after which all risks are covered and insurer pays remaining benefit payments due to members.

Note that a scheme cannot usually be wound up until the premium has been settled in full, e.g. for six years in the above example.

IS THIS OPTION AVAILABLE TO ALL SCHEMES?

Larger schemes have always had sufficient purchasing power to negotiate bespoke insurance arrangements, but the attraction of deferred premium structures is that they are relatively straightforward to set up and available to schemes of any size. Indeed, it is often schemes at the smaller end of the spectrum that could benefit most from an immediate buyout, since the per-member running costs of such schemes are inevitably higher (see research by the Pensions Regulator, published April 2014).

Standard contracts from insurers help make these structures available without significant legal expenses. The main criteria are that the initial premium should be sufficient to at least cover the PPF level of benefits and that the sponsor's covenant is adequate.

ARE THERE ALTERNATIVES?

Depending on the terms available from the insurer and how these compare with the sponsor's corporate borrowing rates, it could make more sense to borrow from a bank rather than an insurer. Under this scenario, the sponsor would take out a bank loan to enable it to pay the full premium to the insurer and hence secure all the benefits. The sponsor would

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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then repay the loan to the bank over an agreed term (similar to the staggered premium payments to the insurer above). One advantage of this approach is that the scheme could be wound up straight away. JLT's dedicated Buyout Team has advised on one such case.

In the event that the insurance policy under consideration does not cover all scheme members, but only a subset of them (often referred to as a 'partial buy-in'), there may be enough assets in the scheme to secure the policy. In this situation, the sponsor would usually make an additional contribution to return the funding position in the scheme to its pre buy-in level. If this is unaffordable for the sponsor and they are unwilling or unable to borrow from an insurer (through a deferred premium structure) or from a bank (as above) then, in some situations, the trustees might allow them to effectively borrow from the scheme. This would involve paying the full buy-in premium from scheme assets, with the sponsor agreeing to additional recovery plan contributions to repair the funding position over an agreed period. In extreme examples, where scheme assets are reduced to such an extent initially that there may be short-term cash flow issues, the sponsor could be asked for reassurance that it will meet unexpected cash flows (e.g. large transfer values) where these arise, with a formal legal record (e.g. a Memorandum of Understanding) underlining this commitment. Our Buyout Team has recent experience of one such deal.

WHAT SHOULD I DO NEXT?

The options described above could make a buy-in or buyout more affordable and enable a transaction to proceed where this was not thought possible before. Although the scheme might not be able to wind up immediately, it would typically be invested in a fully matched asset over the interim period, removing the usual scheme funding risks associated with poor asset returns, falling interest rates, rising inflation expectations, increased life expectancy and so on.

The first step is to understand how much a buy-in or buyout might cost and which options may be suitable. JLT's dedicated Buyout Team 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 and asset value. This feasibility study will also include commentary on suitable options. The Team can support you in discussions with the insurers to agree deferred premium terms.

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 2014, 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 and medically underwritten bulk annuities to fully bespoke de-risking solutions.

Please get in touch.

This Let's Talk does not constitute advice.