

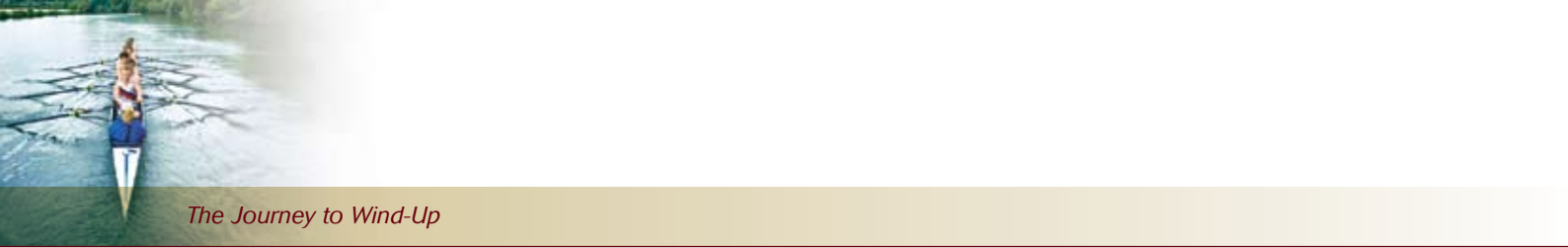


Alexander Forbes

The Journey to Wind-Up

Opportunities in the buy-out market





Opportunities in the buy-out market

Why buy-out?

Buying-out member's benefits involves transferring their liabilities, usually out of the scheme, to a regulated insurance company. When defined benefit (DB) scheme benefits are bought-out this way, the costs are fixed at the point of buy-out and the sponsoring employer and trustee(s) then have no further exposure to:

- *investment risks;*
- *uncertain mortality rates;*
- *complicated regulation.*

Understandably, for many companies, the option to remove DB liabilities from their balance sheet and to wind-up their DB scheme immediately is attractive.

Historically the buy-out solutions available to the small to medium sized enterprise (SME) have been limited in a market dominated by L&G and Prudential. The cost has also been prohibitive. But the emergence of new entrants to the market has made pricing more competitive and buying out benefits is now a viable solution for SMEs.

Background

Most closed DB schemes are in deficit on ongoing funding assessments. These shortfalls are magnified when assessing the cost of purchasing annuities with insurance companies.

Typical pensioner liabilities might be in the region of 20%-45% higher on a buy-out basis than on a typical scheme funding basis.

For non-pensioner liabilities, the differential might be more like 70-130%, the younger the average age, the higher the disparity.

Some of the reasons for this higher cost can be summarised as follows:

- *Insurance companies are subject to solvency regulations which restrain their ability to price optimistically:*
 - *They must regularly prove their solvency on a low risk asset basis,*
 - *They must maintain a resilience reserve,*
 - *They must demonstrate to the FSA that they are taking a cautious approach on mortality and expenses,*
- *Insurers understandably wish to make a profit on the business written.*

New entrants to the market

Paternoster, AEGON, Goldman Sachs (Rothesay Life) and others have entered the buy-out market over the past few years. The expanded market and innovations designed to overcome regulatory barriers have made pricing more competitive.

We believe that SMEs should consider the following options:

Buy-out of deferred members via a stream of regular payments

This suits businesses that have already bought out current pensions in payment, where there is a deficit that is being funded over the long-term by the sponsor. It is the creation of a market for gradual rather than cliff-edge wind-ups.

The approach permits the trustees to invest in higher-risk assets in the meantime, rather than locking into the gilts required by the insurer, while fixing the price of the liabilities at the outset.



Phased buy-out

This presents an opportunity for trustees to buy-out different subsets of the benefits, one at a time. The subset might be either:

- a) the full stream of payments for a particular group of members, or
- b) all the payments over a specified period for all those members receiving benefits during that timeframe.

a) Buying-out separate groups of members

This has always been available to some extent (i.e. buying-out current pensioners), the recent development is that the price for subsequent groups will be agreed up-front rather than at a later date, thus removing exposure to adverse mortality changes.

b) Buying-out distinct slices of future cashflows from the scheme

This approach involves the insurer modelling all expected future cashflows from the scheme. The scheme is quoted a premium to insure all of these cashflows.

Alternatively insurers are willing to accept a pro-rated premium to insure only the next n years' worth of those cashflows, and while doing so, will agree to fix the basis for the premium today for subsequent slices of cashflows should the trustees/ scheme sponsors find themselves able to raise further funds at a later date.

This allows scheme trustees to seek higher returns from their investments to cover longer-term liabilities.

The phased buy-out approach gives the trustees absolute certainty that the liabilities falling due in

the first period are fully matched; the trick then is to generate sufficiently high returns from the remaining assets to be in a position to finish the job off (by securing the benefits for those younger deferreds) later. If the expected out-performance from their retained assets comes through, then the trustees avoid the risk that the annuity market has, in the meantime, escalated out of their reach.

This method, known as 'regulatory arbitrage', side-steps the restrictions on the insurer's pricing structure and draws on the scheme's ability to run a deficit. It also allows trustees to remove future longevity risk, should they wish to do so. If however more members die in the first horizon period, or if expectations of future mortality reverse, then the trustees of course have the right to let the option lapse and instead either:

- *retain the responsibility for paying subsequent (i.e. post-horizon) cashflows from the scheme, or*
- *obtain a fresh insurance quote for their buy-out.*

Why work with us?

Winding up a DB scheme is a complex process requiring a variety of skills from a team of advisors and providers. We can provide these services and can help corporate sponsors and trustees secure, in full, their members' benefits.

If you would like to discuss your pension scheme with our experts please call

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