# Willpower

JOHN HAWKINS DRAWS SOME CONCLUSIONS FROM THE SECOND OF HIS TWO-PART EXAMINATION OF SECURITY ISSUES IN PENSION BUY-OUTS AND BUY-INS.

## Executive summary

- The ability of corporate treasurers to add value in pension transactions is increasingly clear. This article, the second of two, explores some of the issues of which treasurers should be particularly aware when a pension scheme is considering a buy-out or a buy-in. Given their credit and security expertise, treasurers should definitely be involved in buy-outs or buy-ins. Also examined are the structure of the Pension Protection Fund and the Financial Services Compensation Scheme, and syndication issues.

By 2012 the Pension Protection Fund (PPF) is expected to have around 250,000 members, and ultimately the number could double. The PPF came into existence because it was politically unacceptable for members of occupational pension schemes to be left without a pension when sponsors failed after employees had been encouraged by the government to save in such schemes. Another political reality is that the PPF cannot collect premiums fast enough to keep pace with the liabilities it is taking on: raising them to a market level is not an option for any hue of government. But the declining number of defined benefit occupational pension schemes – and thus a lower revenue base – will exacerbate the situation. At some stage it is even possible that the PPF will have to cut back on benefits, which in any event are subject to caps and limits. Yet the PPF's benefits have to be regarded as secure and provide an effective benchmark for alternatives.

**FINANCIAL SERVICES COMPENSATION SCHEME (FSCS)** The FSCS is a horse of a different colour. Set up as a fund of last resort, it covers not only insurance policies in the event of insurer insolvency, but also deposits and other financial arrangements. As with the PPF limits apply, although it is fair to say the PPF and the FSCS would offer a similar level of protection in principle to the typical pensioner.

But the FSCS was not set up as a funded scheme; any claims are met by a post-event levy on the class of financial firms involved. The FSCS does not, therefore, have the inherent strength of the PPF. On the other hand, recent events suggest that if there are calls on the FSCS, initial government funding will be provided immediately, and industry levies collected subsequently to pay the government back.

The question has also been raised as to whether bulk annuity policies sold to a pension scheme would benefit from the FSCS. The consensus answer at the moment seems to be yes, with the caveat that this was probably never the intention of the government. The government is likely to review this area and eliminate the double cover by the PPF and FSCS one way or another. Future governments may give consideration to changing the FSCS's funding basis to something more like the PPF so that the beneficiaries of FSCS and PPF guarantees could be seen as being treated equally in the event of a sudden rush of annuity insurance company failures.

**THE COMPARATIVE SITUATION** This is an appropriate point at which to consider, from the point of view of scheme members, the covenants from which they would benefit over the long term in the three cases of a traditional ongoing scheme able to enter the PPF, a buy-in and a buy-out with wind-up.

| | Traditional | Buy-in | Buy-out |
|---|---|---|---|
| Sponsor | Yes | Yes | No |
| PPF | Yes | Yes | No |
| Insurer | No | Yes | Yes |
| FSCS | No | Yes? | Yes |

Even with some uncertainty over the availability of double cover, it does seem to offer an advantage to the buy-in, although this may not be the most effective way of achieving the overall amount of interest rate, inflation and longevity de-risking involved.

**STRENGTHENING THE INSURER COVENANT** The creativity of annuity providers is frequently underestimated. Previous articles in The Treasurer have listed and described the various flavours of buy-outs developed over the past two or three years. What may be less well known is the amount of structuring that has gone into some of the policies that have been purchased, some of which have involved limiting the ability of the insurer to transfer the book of business elsewhere (at least for an initial period) or improving the security of the arrangements from the perspective of the annuity buyer. For reasons that we will come to, these have so far tended to involve buy-ins rather than buy-outs. The structures most often described and discussed, although not all have been implemented, involve

either retention of part of the premium in a security or escrow account (which is released over a period of time), or a floating charge over a portion of the assets associated with a given annuity. Such arrangements are strongly resisted by insurers: at the least, they give rise to issues of cost and complexity, some of which will affect the premium charged. In the case of a buy-in, however, it is perfectly possible for the scheme trustees to monitor such arrangements on an ongoing basis once they have been put in place.

One of the arguments used by insurers to reject such requests in the case of buy-outs and wind-ups is that there is no obvious party to monitor such arrangements after the scheme has been terminated and the trustees released. But this is not quite true. Treasurers will be very familiar with two concepts that could be applied in such cases if the sponsoring company or trustees felt sufficiently strongly about the issue and were prepared to insist on a solution: the escrow agent and the bondholder's trustee.

In practice, the latter is more likely to fit the bill. Many bonds are issued under an indenture that provides for an independent firm of bond trustees to monitor the covenants in the indenture. The duties of the bond trustee are also set out in the indenture and provision made for their remuneration. In principle, there is no reason why a similar arrangement could not be built into a bulk annuity purchase agreement. The annuity provider would be responsible for remunerating the trustee on an ongoing basis and the bond trustee would probably also require the benefit of a single premium credit insurance policy (from a different insurer). While insurers would doubtless be horrified to think that their actions could be constrained for 50 years into the future, competition is currently such that treasurers who become involved with such negotiations should not be put off by the absence of close precedents.

**SYNDICATION** Syndication is normally discussed in the context of increasing buy-out market capacity by one or more insurers joining together to write a large piece of primary business. It is typically mentioned in the context of potential deals with a premium above about £1bn. Of course it could also be used, at least in theory, proactively by trustees to diversify the risk of members. In practice there could be a number of structuring difficulties; for example, if two fronting insurers were involved in a co-insurance arrangement, would each provide half of every member's benefits and what would happen in the event of default by one of them? For a £5bn scheme seriously considering a buy-out, these questions may need to be addressed, but for smaller schemes the effort may be better expended elsewhere. However, as part of the due diligence process, trustees especially should ensure that they understand the impact of any reinsurance arrangements into which the fronting insurer intends to enter.

In the case of buy-ins the issue can be more important. In fact, if a series of buy-ins is done for different classes of members with different insurers, the issue can arise almost by accident. In such cases, trustees need to have a clear idea of their final game plan and, if wind-up is eventually contemplated, that this will not be jeopardised by the structuring of individual buy-in transactions.

**A REAL ALTERNATIVE** The treasurer involved in a buy-out or buy-in discussion, whether wearing a sponsor or a trustee hat, should bear the following in mind:

- There are superficial attractions to a buy-in (especially from the perspective of a trustee), but more cost-effective ways to achieve the same risk reduction may be possible. Also, fully understand the impact of a buy-in on the scheme's long-term game plan.
- For the elimination of all ongoing risks, other than that of the covenant of the corporate sponsor or insurance provider, a buy-out and wind-up is the only real alternative for both trustees and sponsors.
- Winding-up a scheme requires trustees to discharge liabilities in a prescribed manner, which carries some risks, and both the sponsor and the trustees will need to manage associated reputational risks.
- Trustees should request, and treasurers should expect, sensible levels of covenant protection to be built into funding agreements for schemes that do not wind up.
- It is perfectly legitimate for scheme trustees and treasurers to explore mechanisms for enhancing the security of annuity providers for both buy-ins and buy-outs, but enthusiastic agreement from insurers should not be expected.

In the long run, as uncertainty increases and the probability of corporate failure rises, the security of traditionally run schemes must depend heavily on the willingness of government to preserve PPF benefits at current levels, facilitating funding of the PPF if required.

For schemes that buy out and wind up, the long-term outlook for members is dependent on the vigilance of the Financial Services Authority and the willingness of government to preserve and fund FSCS benefits.

From the point of view of the trustee and scheme member, buy-out and wind-up exchanges one type of long-term uncertainty for another, something that will have to be carefully assessed. Of course, this change will not necessarily involve a deterioration and, if the sponsor provides additional funding, an improvement to benefits or some other sweetener, the trustee may be able to demonstrate more easily that members are not leaving the frying pan for the fire.

Nobody ever said pension choices were easy.

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