Ask the experts:

Are buy-outs inevitable?

THERE SEEMS LITTLE ALTERNATIVE TO INSURANCE BUY-OUTS OF DEFINED BENEFIT PENSION SCHEMES.

ERAS AND ERRORS

Con Keating, head of research, Brighton Rock

It is difficult to resist describing the closure of the Royal Dutch Shell defined benefit pension scheme to new members as an epoch-defining event. When the company with the largest pension scheme voluntarily withdraws from the field, the difficulties become common knowledge, if they weren't already so. With liabilities of £43bn and contributions of £1.3bn last year, the Shell scheme is the largest in the UK. It is also not in any distress – scheme funding was 96% and the scheme is small by comparison with the company in both cashflow and capital terms.

Make no mistake: closure of the Shell scheme to new members was not a pressured decision but a matter of commercial judgment. The scheme, like all such funded occupational schemes, no longer offers value for money to employees and employer sponsors. Closure, itself, has an explicit cost, with existing liabilities costing more to provide for closed schemes than open.

Does the closure matter when defined contribution (DC) pensions are being offered in replacement? Unfortunately, yes, it does. As a pension is simply an income in retirement, DC arrangements are merely tax-advantaged savings schemes rather than pensions, and hopelessly inefficient relative to collective defined benefit (DB). The scale of this inefficiency is huge; it currently costs twice as much to produce a pound of pension under DC as DB.

The sources of this inefficiency are the absence of the risk-sharing and risk-pooling of the standard DB model, to which must be added the economies of scale and scope of large-scale collective organisation. The risks faced by members under individual DC are not only borne alone, they are also far larger than under DB. The scale of risk should not be underestimated. Around 90% of pension income is derived from investment returns rather than contributions and half of that arises after retirement. The ultimate results of the DC trend must surely be greater inequality among pensioners and lower pension incomes. There are important social policy issues here.

DC is attractive to sponsor employers precisely because it eliminates recourse to them. This, itself, is inefficient. Economically a pension is a claim on future production, and occupational DB pensions are claims on their employer sponsor's future production. This direct dependence is more efficient than the indirect process of buying equities and bonds, themselves claims on future production, in financial markets. Properly speaking, a DC occupational pension is neither a pension nor occupational.

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Accounting and regulation are the true villains of the piece. Regulation has failed its most basic test, costing far more than the harm it was intended to address. In fact, regulation has even been counter-productive as it has increased the primary risk that schemes face, which is sponsor insolvency. The funding focus is misconceived. The costs of regulation are now so high they overwhelm the efficiency advantages of DB, raising costs to the point that it is sound commercial management, albeit costly, to cease their provision.

Risk-based solvency regulation might be appropriate for banks and possibly insurers but is wholly inappropriate for DB pension schemes with recourse to their sponsor employers. The balance sheet approach taken by regulation is not even market-consistent. In bond markets, default on a payment defines (equitable) insolvency and determines bond yields. In the regulatory hall of mirrors, it is estimates of capital values that dominate. The difference between a promise to pay small sums over time and a requirement to raise capital equivalent to the totality of those sums seems to be poorly understood beyond The Treasurer's readership.

One question for closed schemes is how to manage their run-off – the discharge of existing pension liabilities. Many advocate bulk "buy-out", although this is extremely costly – at present about 50% of liabilities. Few of the insurance companies offering these contracts have the credit standing or sustainability of the Shell business model. Managed run-off appears the commercially sound decision for Shell.

The important issues, though, are the characteristics of the new epoch. Retirement issues in social policy are more important than ever. If we continue as we are, we face a future where retirement penury and immiseration will be prevalent. It is, perhaps, time to remind our government and regulators that pensions must be adequate to be sustainable, and that their role is to permit and enable efficient production. The alternative is a shameful legacy for our children.

SOLUTION TO A TREASURY HEADACHE?

David Norgrove, chairman, Long Acre Life, and former chairman of the Pensions Regulator

With the need to manage pension risk moving up the corporate agenda, many treasurers and CFOs have looked towards the buy-out market. Yet few have transacted. The insurance industry needs to create a better proposition than what is currently available.

Rising longevity, poor investment returns and, it could be argued, increased regulation have seen the cost of providing a defined benefit pension scheme soar beyond a level most treasurers or CFOs are willing to tolerate. Hence an increasing number have moved to close their schemes to new members in order to cap their pension costs, with Shell merely the latest in a long line of blue-chip companies to take such action.

Yet while scheme closure signals a significant step on the road towards the end game, it does not remove a company's obligation to pay its previously accrued liabilities – hence the need to manage pension risk remains. Left unmanaged, DB risk can impact a company's credit rating, share price, ability to attract capital and even its future viability. Indeed, the FTSE 100 includes no fewer than 10 companies with pension liabilities greater than their market capitalisation.

Some schemes have attempted to address this problem by looking to derisk distinct groups of members or by removing risk components individually through hedging or swap contracts, with limited success. Undoubtedly, buy-outs – where all accrued pension liabilities are completely transferred to an insurance company in return for a premium – offer the most holistic solution. Yet to date the market has only attracted £25bn of business (a figure that includes buy-ins), or 2.5% of the total value of DB liabilities sitting on the balance sheets of UK plc. For the buy-out market to fulfill its potential, it is clear that the industry needs a shake-up.

A lack of corporate disclosure about the true nature of the DB pension risk, and the infrequent use of technology to measure and manage this risk, are undoubtedly key barriers that need addressing. But first, the insurance industry must tackle perhaps the greatest hindrance to a buy-out: the cost. Understandably, most pension schemes are unwilling to pay a 40% premium to remove their DB risk, especially as this premium will be an immediate hit to the sponsoring company's P&L.

The answer may come in the form of captive insurance, where a company forms its own insurance company subsidiary to carry its risks. If set up by a pension scheme, captives would naturally retain the profit otherwise paid to an insurer. Yet a pure captive solution for delivering pension buy-outs would also compound the pension liability (and the problem) on the sponsor's balance sheet.

So a solution is required that delivers the economic benefits of a captive through a mutually owned insurance company (the idea behind Long Acre Life). This solution not only removes the need to consolidate the liability, it offers significant cost savings. Indeed, such a buy-out could ultimately reduce the hit to the company's P&L by 20% or more.

Of course, the cost of implementing a buy-out strategy is also intrinsically linked to the scheme's current funding measure and its position with respect to volatile investment markets. Recently, opportunities have existed to transfer components of risk from pension funds to insurance companies for a small premium over their IAS 19 liability (even as recently as early last year when the combined deficit of the schemes of the FTSE 100 fell by £54bn in six months). Yet the vast majority of schemes failed to take the opportunity to lock in improvements in funding levels, and so slipped back into deficit when markets took a turn for the worse.

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Unfortunately, CFOs may have to accept that such heady days may never be seen again. Yet continuing to leave their schemes exposed to a significant amount of financial risk, which, given the volatility of the markets, could have a significant impact on the company's financial performance, should not be an option.

And with the cash position of UK plc looking remarkably healthy (UK companies' cashflow has grown 40% since the depths of the financial crisis, with that cash earning negligible returns), now may be a good time to act. For many, the opportunity to remove a volatile risk in return for an asset on the balance sheet offering a stable annuity-based income would be seen as a good use of shareholder funds.

REVISIT THE FUNDAMENTALS

David Ellis head of pension buy-outs, Mercer

Sponsoring a defined benefit pension plan can be a risky business. No company enjoys bearing the risk of unexpected cash calls if the plan's existing assets are judged insufficient to make good the retirement benefit promises. And if the law did not require them to, few companies would choose to offer financial support to a DB pension plan that principally benefits their ex-employees while their current staff are mainly served by a less generous defined contribution arrangement.

With an ever increasing range of products and strategies available in the UK for managing and transferring pension risk, many companies would be forgiven for needing to step back and revisit their fundamentals. For example:

- What is the likelihood that the pension plan could significantly damage the company's share price or debt rating, impair the raising of capital or prevent the sale of a subsidiary?
- Could the pension plan's need for additional funds place the company in danger of insolvency?
- If a product or strategy to manage risk is pursued, who is likely to gain the most and why?
- What is the likely risk-adjusted return on any capital employed in fixing the plan's finances, and how does this compare to the likely return on alternative investments?

- Does the company believe there is spare capital embedded in the plan which it will be able to access in the future if it retains responsibility for the plan?

Insured buy-outs – that is, purchasing annuities to transfer responsibility for a plan's benefit promises to a third-party insurer – are a mainstay of pensions risk management. Unlike some alternatives, buy-outs have been employed in the UK for 25 years and are legally recognised as the de facto route to closing down a pension plan. There are cheaper alternatives to achieve similar but different outcomes, but the maxims "you get what you pay for" and "a bird in the hand is worth two in the bush" are worth bearing in mind here. Other than by transferring assets and liabilities to another pension arrangement, a buy-out is the only way to wind up the plan and so remove it from the company's balance sheet.

Many companies may have considered a pension buy-out for their pension scheme before now, only to conclude that the expected cash cost to the company was too large to bear. It's clear that many more would buy out and wind up their plans if they thought they could.

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So what can be done? A recent development makes it possible to spread the buy-out payment over time. The full cost of a pension buy-out still needs to be met, but insurers will entertain providing 100% cover at the outset with, for example, only 75% of the premium paid up-front and the balancing 25% paid over the following five years. This can make a buy-out much more palatable.

In addition, payment for any deferred element of the premium needn't necessarily be in cash, with, for example, insurers willing to accept company debt and/or property sale and leaseback arrangements as part-payment. Also, the company's contributions into the plan are set according to prescribed terms that won't change during the deferral period. From the outset, the insurer takes on the risks arising from the key uncertainties affecting the plan – investment returns, interest rates, inflation and longevity – so they can no longer impact the company's contributions.

That said, closing down a DB pension plan is often not easy. Beneficiary data is often poor and takes time to fix, while the trustees will need to ensure that no beneficiary is worse off as a result of closing down the plan. And there can be significant risks and problems associated with negotiating and executing a typically bespoke contract with an insurer. But a pension buy-out may be worth the effort and expenditure, clearing the way for the organisation to focus on its business, undistracted and unencumbered by a DB pension plan.

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