Security issues

IN THE FIRST OF TWO ARTICLES, **JOHN HAWKINS** CONSIDERS PENSION SCHEME BUY-OUT AND BUY-IN BASICS, AND APPROACHES TO ASSESSING SPONSOR AND INSURANCE COVENANT STRENGTH.

Executive summary

- The ability of corporate treasurers to add value in pension transactions is increasingly clear. One area where they should be involved, given their credit and security expertise, is when a pension scheme is considering a buy-out or a buy-in.

For those who have seen the headlines, but not read the detail, in the context of a pension scheme a buy-out involves the purchase by the scheme trustees of an insurance policy (an annuity) that satisfies the contractual pension benefits of all scheme members.

A buy-out (or bulk annuity purchase) is invariably followed by the termination of the scheme, usually known as wind-up, a process that can take several years. The purchase of bulk annuities for scheme members still accruing benefits is quite difficult, so in practice the process of buying-out and winding-up is usually limited to schemes that have not only closed to new membership, but also frozen future accruals (so they have only current and deferred pensioners).

A critical element of buying-out and winding-up is that once the process has been completed, the trustees are released from their responsibilities and the sponsoring company has no further financial liability. If the scheme was previously eligible for the Pension Protection Fund (PPF), it will not be from this point on. Scheme members will each have an annuity policy with the insurer providing the bulk annuity (which will have been allocated between members); in the event of a default by the insurer, the policyholder will have recourse to the Financial Services Compensation Scheme (FSCS).

For a scheme sponsor, the purchase of a bulk annuity for some of the scheme's members (for example, current pensioners) removes three of the biggest risks – interest rate, inflation and longevity – making it the ultimate liability-driven investment (LDI) strategy.

Leaving aside the very thin and illiquid nature of the longevity hedging market, the implicit trade-off is the additional cost of buying this hedge from an insurance company as opposed to synthesising it in-house. These additional costs will not be examined in detail here, but in the most basic analysis they represent the insurance company's charge for capital (since it is required by legislation to maintain minimum reserves) and its desire for profit. If the annuity provider is taking over the administration of the pensions (which does not have to be the case), the cost will be slightly higher, but there should be some offsetting savings.

A scheme that purchases such a policy for all its members and then winds up eliminates additional risks, including:

- fiscal (such as the tax treatment of contributions and income);
- regulatory (such as higher minimum funding levels and PPF levies);
- operational (such as underpayment and overpayment of pensions);
- counterparty (such as in relation to derivatives transactions); and
- ongoing reputation and governance.

Any analysis of the financial consequences of a buy-out and wind-up obviously needs to take into consideration the elimination of future administration costs and PPF levies.

THE BUY-IN Let's return for a moment to the halfway house: buying an annuity for some (or even all) members, but not proceeding immediately to wind-up; in other words, holding the annuity as a general asset of the scheme, albeit with its income directed towards particular members. Such a scenario is described as a buy-in. Its proponents give a number of reasons why schemes might like to consider such a strategy, including the following.

The members for whom annuities are purchased can be cherry-picked. For example, because annuities for current pensioners are shorter-dated than those for deferred pensioners, they are less risky (for the provider) and less costly to provide; if analysed only superficially they can therefore appear cheaper.

Even schemes fully funded on an IAS 19 basis are likely to be underfunded on a buy-out basis, so that full buy-out of all member classes may simply not be an option without additional funding. While this is true, if only partial de-risking is possible, there may be more cost-effective ways of achieving this.

If an annuity is held as an investment, the scheme remains the financial responsibility of the employer, continues to be eligible for the PPF and, if the insurer providing the annuity defaults, there is also the FSCS guarantee of the insurance policy. At first sight this appears quite attractive, but it is a difficult benefit to quantify. It also raises

some interesting questions about the relative strengths of employer and insurance company covenants, how the relative strengths of the PPF and the FSCS guarantees might change in the light of the political environment of the day and, indeed, whether both guarantees would continue to be available to members in all circumstances.

Since the policy remains an asset of the scheme, the question arises as to what happens to it if the sponsor defaults or the trustees change their minds as to its attractiveness. This will depend critically on how the policy is worded. In practice, the trustees must at least retain the right to redistribute the policy in a different way should certain circumstances occur, such as sponsor default.

SPONSOR COVENANT ANALYSIS Encouraged by the Pensions Regulator, pension scheme trustees have greatly benefitted the consulting industry over the past few years by commissioning reams of analysis of the financial strength of their sponsors. At their best these reports will cover at least the following:

- a structural analysis, showing how the pension scheme liability ranks as to priority, security (if any) and relative size with the other principal liabilities of the sponsor, or sponsors;
- a fundamental financial analysis, using traditional credit indicators and peer group comparators;
- credit rating agency reports of the sponsor, or companies to which it is closely related (such as its immediate or ultimate parent);
- market-implied ratings of the sponsor or its parent, such as might be available from bond spreads, credit default swap prices, or proprietary models (such as Moody's KMV); and
- other external credit indicators, such as D&B failure scores.

In an ideal world, the outcome of such an analysis should not just be the presentation of the report, but a properly documented funding plan that provides appropriate priority and security, and which links scheme contributions to the sponsor's creditworthiness.

Even with a high-quality report and a properly documented funding plan, the shortcomings and short-term focus of all of the above analytical techniques should be self-evident. In a recent forum on pension buy-outs, a well-respected financial journalist made a comment to the effect that indubitably blue chip companies should be given considerable freedom in how they managed their pension affairs. Presumably, he did not have in mind former blue-chips such as Enron, WorldCom and Lehman Brothers. Some of the rating agencies and proprietary model providers will provide statistics enabling a 10-year credit view to be taken, but how relevant is this when the duration of the scheme liabilities is 15 to 20 years and the ultimate liability may be 50 years in the future?

INSURANCE COMPANY COVENANT ANALYSIS Most treasurers have a good fundamental understanding of the credit analysis of industrial and commercial companies and a working knowledge of bank creditworthiness. But even those who have had responsibility for managing insurance departments will generally be less comfortable in the area of insurance company creditworthiness. In the case of annuity providers, the situation is further complicated by the existence of two main classes of business writers:

- long-established diversified firms, often with credit ratings; and
- recently established mono-line insurers, usually unrated.

There are, of course, specialists in the area of insurance company risk, such as AM Best, the credit rating agency, and financial risk consultants, including Oliver Wyman. But the main applicability of credit ratings will often be to relatively short-term business. For long-term business, especially in the reinsurance market, it is not at all uncommon for insurers to provide collateral, often in the form of letters of credit. This will also be a familiar technique to treasurers involved with managing captive insurance companies. In the absence of collateral, the strength of an insurance company covenant in the long term depends on confidence in the ability of the Financial Services Agency (FSA) to properly exercise its regulatory responsibilities (for example, in relation to policing capital adequacy and risk controls) and the continued existence, availability and funding of the FSCS.

Some insurers say their intention is to hold capital in excess of the FSA minimum, but whether such an intention has high value over the whole life of the scheme's liabilities is doubtful. Even in the short term it is worth asking potential counterparties exactly how committed their capital is (when it is not fully drawn down) and how many of such commitments have been made by institutions themselves now looking for capital, or with other priorities.

RELATIVE STRENGTHS These considerations are important in any analysis of whether a buy-out or buy-in makes sense for a particular pension scheme and contribute to an examination of the comparative strengths of the original sponsor and possible annuity providers. However, the relative strengths of the two guarantee funds will also be relevant and in the second part of this article we will be looking more closely at the PPF and the FSCS as well as syndication issues and strengthening the insurer covenant.

John Hawkins is a director of Foresight Trustees.
johnwh@foresight-trustees.co.uk
www.foresight-trustees.co.uk/index.html