The start of the journey

Executive summary

- Developments in the pensions buy-out market continue to arrive thick and fast, marking out a vibrant sector experiencing healthy growth and bucking the mood of economic gloom elsewhere. New market entrants are expected, which promises to end the era of relative stability; the wider range of products they will bring will also make the buying decision more complicated.

The torrent of news in the pensions buy-out market is a mixed blessing for those involved in taking the decision about the future of their schemes. On the one hand, new entrants are likely to increase the competition vying for their business, which should help schemes achieve a more cost-effective outcome. On the other, it may be more difficult to decide on the best course of action in such a fast-moving market.

And the journey is only in its early stages. One of the new entrants, Paternoster, recently forecast that the buy-out market could reach £12bn this year, up from under £3bn last year. Watson Wyatt found in a recent survey that half of the employers running defined benefit schemes expected to attempt to remove their defined benefit legacy – either through a pensions buy-out or another type of transaction – within the next 10 years.

NEW ENTRANTS Swiss Re and Lehman Brothers are reported to be on the verge of becoming new entrants, and the pace of transfers seems to be accelerating, most notably among the blue chips, with reports suggesting that Cable & Wireless is preparing to offload risks relating to its £2bn pension plan, following similar moves by Friends Provident, Lonmin and Rank.

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The recent domination of the market by Legal & General and Prudential has come to an end as new entrants have grasped the opportunities on offer. The breakup of the status quo is a positive move but also heralds the end of an era of relative stability and the creation of a more complex environment requiring more careful navigation than ever before.

Those involved in making decisions about the future of their defined benefits scheme – finance directors, treasurers, trustees – are coming under more pressure to judge the merits of the growing number of options available and to make informed decisions about the appropriate solutions for their own fund.

The traditional solution – and the one likely to be front of mind for any corporate wishing to divest itself of its pension scheme – is to arrange for the pension fund to be bought out by an insurance company. Because the funds are fully invested in defensive assets such as gilts and low-yielding bonds to match the future liabilities, growth prospects are low and this results in a high premium to the company seeking to offload its scheme. Even companies in the fortunate position of having the financial resources to take this route are still well advised to scrutinise its cost-effectiveness against many of the more innovative solutions being introduced.

In reality, many companies will find that a full buy-out is beyond

BEN SHAW SURVEYS THE POSSIBILITIES FOR THE PENSIONS BUY-OUT MARKET.

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them, either on cost or practical grounds. The rapidly increasing demand is making even the established players rethink their strategies to focus on the most lucrative business, usually the bigger schemes. Paternoster recently admitted it can no longer provide buy-out quotes for schemes smaller than £20m.

INCENTIVE IN EXPLORING OPTIONS Companies which face serious underfunding issues – likely to be an increasing number given the current economic situation – may fall into the Pensions Protection Fund (PPF) assessment period. As soon as they enter this assessment, members' benefits are cut back to PPF levels, so there is a real incentive to ascertain the options available quickly.

If the fund can afford to approach an insurer (such as L&G, Prudential, Lucida or Synesis) and obtain a better level of benefits for members, the PPF will direct trustees to do so. Unfortunately, in practice few schemes already in the PPF assessment period are in a position to do this, so the orphaned funds with insufficient resources will enter the PPF.

Entering the PPF is an unappealing prospect for many schemes. While it provides a lifeboat for schemes in large deficit, it can have a severe impact on members' benefits. Payouts to members are generally significantly less than the payout they expected. Many members will have their pension entitlement cut by 10% and for high earners the reduction might be substantially more. This is partly the reason for the PPF's lengthy assessment period: it is the final opportunity for trustees to explore all their options, and to overcome data cleansing and legal issues.

But between the two poles of the insurance company buy-out and the PPF, a host of new options have been developed. One alternative has been created by Pensions Corporation, which buys a company, sells the business and keeps the pension scheme on the basis that it can still be run profitably. While the model has been severely criticised by the Pensions Regulator because it reduces the value of the employer's promise to support the scheme (the employer's covenant) it does enable a pension scheme to be run as a separate entity from the company, freeing the former sponsor from the burden of having the pension scheme liabilities on its accounts.

PARTIAL BUY-OUTS Another type of solution is the partial buy-out, which promises to slice off the liabilities and involves a payment to take on some liabilities but not others. Companies involved in this area include Rothesay Life (part of Goldman Sachs) and Goldman Sachs itself, along with Aegon, MetLife and Aviva. The downside is that pension schemes face several different types of risk and while partial buy-outs may deal with some of these, others will remain.

Finally, an option has been launched that effectively frees the company from its employer covenant but keeps the fund running as an occupational pension scheme, with trustees working on behalf of its members. This model, offered by Occupational Pensions Trust, could be suitable where an employer can make a cash injection to meet a minimum funding level (but cannot afford the premium required for a full insurance company buy-out), where a scheme is under threat of falling into the PPF and wants to maximise member benefits, or where a company executing a takeover wants to offload the target company's liabilities.

The potential advantage of this model is that assets can continue to be invested in growth-oriented assets (equities, bonds, hedge funds, property, commodities, and so on). The PPF or an insurance company, on the other hand, must make ultra-conservative assumptions about the investment returns into their funds.

The higher level of expected return increases the chances of the scheme being able to pay member benefits in full, or, if targeted returns are not met, at a higher rate than would have been available from the PPF. Ultimately, the PPF lifeboat is still available if things do go awry, but even in this worst case scenario members would have benefited from the higher level of benefits in the interim.

Those facing tough decisions about the future of their schemes may be daunted by the huge amount of activity but should be cheered that overall events seem to be moving in their direction with more entrants and tougher competition among the providers. The market may be becoming more complex, requiring more work to sort through the various options, but the end result should be a far better solution to the needs of both the company and the scheme members.

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