

The attractions of the current buy-out market

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1. Introduction

The previous chapter considered the alternatives that are available to those trustees and employers of a pension scheme that do not wish to buy out the defined benefit pensions liabilities with an insurer. This chapter considers the factors in the current market which have been attracting other trustees and employers either to buy out those liabilities or otherwise to remove them from the employer's balance sheet. It also considers whether some of those attractions have, in fact, been overstated in the early days of the new buy-out market.

During 2007 and early 2008 the principal attraction of the new buy-out market was the realisation that buy-out prices were shrinking. By contrast, defined benefit pension liabilities had only been growing and, in the wake of Financial Reporting Standard (FRS) 17, had taken root on the employers' balance sheets. In 2007 the two established players in the buy-out market, Legal & General and the Prudential, had been joined by more than 10 other players of varying sizes and the amount of business transacted increased dramatically. Less than £3 billion of business had been written in the whole of 2007, but almost £4 billion was written in the first half of 2008 alone.

Any analysis of the buy-out market must be qualified by an acknowledgement that market conditions have been changing rapidly and should be expected to continue to do so. Certain themes can be identified, but it is not possible to say with any certainty how the market will develop even in the very near future. In particular, the full impact of the credit crunch and the remarkable volatility in the equity markets in late 2008 will not become clear for some time. In the first half of 2008 it seemed that the credit crunch was barely having any impact on the market at all, but by the fourth quarter of the year it appeared that business had all but ground to a halt. Nevertheless, despite the rapid changes taking place in the buy-out market, there is no denying that there has been a fundamental shift in the attitude of both trustees and employers towards the possibility of buying out defined benefit pension liabilities since early 2007, and that the market is unlikely to return to the way it was before then.

2. Underlying factors

The increasing attraction of buying out must correspond to some degree with the fading popularity of the defined benefit schemes themselves. In the period between the passing of the Pensions Act 2004 and the end of 2007, the following factors

heightened employers' and shareholders' awareness of the cost of providing defined benefit pensions or actually increased the (already high) cost of providing those benefits; or in some cases did both.

2.1 Increased regulation and governance requirements

The Pensions Act 2004 introduced the pensions regulator and the Pension Protection Fund (PPF) to the world. The increased regulation and governance requirements which they have imposed on trustees and employers have undoubtedly increased the cost of providing defined benefit pensions on a day-to-day basis.

The regulator, in particular, has transformed the pensions landscape in the United Kingdom by introducing a new layer of regulation to many aspects of corporate activity and has thus raised the awareness of the cost of providing defined benefit pensions. The regulator's mandate extends to supervising the effects of mergers and acquisitions, internal group restructurings and dividend payments, among other activities, which many employers had previously pursued without considering pensions matters too deeply. Since the regulator prefers to be a passive third party, the onus is on employers to determine whether they ought to approach him (or whether the trustees of their pension schemes will want to do so) prior to embarking upon any new project. This need to stop and think about the level of the pension scheme's liabilities before embarking upon such activities has thrust pension schemes into the limelight.

No one could argue, post-Maxwell, that if an employer has chosen to provide defined benefit pensions for its employees, it should not fulfil the obligation to do so properly. Appropriate regulation and governance in that sense are not unwelcome. However, since 2004 even employers that are acting properly must meet the additional expenses of being seen to be acting properly and of deciphering the new legislation. In October 2008 Hewitt Associates estimated that a single clearance application could easily cost £200,000 once the input of all parties is considered.

2.2 Accounting requirements for pension benefits

FRS 17 was introduced in stages between 2001 and 2005. It brought a realisation for many companies that their pension scheme liabilities were a current problem and not just a future one. Before FRS17, finance directors, shareholders and investment analysts had been accustomed to accounting for pension costs under Statement of Standard Accounting Practice (SSAP) 24. This required an employer's contributions to a defined benefit scheme and its net exposure to the scheme to be shown in the accounts using the scheme's own long-term actuarial funding basis. As a result, the value of assets and liabilities could be smoothed over the long term and there was no common basis for comparison with other companies' accounts. FRS 17 (and International Accounting Standard (IAS) 19) placed defined benefit pension liabilities on the balance sheet and required that liabilities be measured using market values for the first time. FRS 17 also required all companies to use a standard set of actuarial assumptions for determining liabilities, allowing comparisons between the balance sheets of different companies for the first time.

In brief, FRS 17 had to be adopted by UK companies for all accounting periods

following January 1 2005 (to reflect the requirement for all EU companies to satisfy the terms of the international accounting standard, IAS 19, with effect from that date). Although an improvement on SSAP24, FRS17 is flawed. The FRS17 assumptions focus on AA corporate bonds, regardless of what is happening in the markets and the scheme in question. In particular, it presents a further problem for employers since it gives only a snapshot of the funding position (surplus or deficit) of the scheme on the balance sheet.

If the FRS 17 snapshot is taken on a particularly good day or a particularly bad one, the figure which appears on the balance sheet for that year may not be truly representative of the overall position of the scheme. As a result, a company which has worked hard to improve the funding level of a scheme over the course of a year is not guaranteed to reap the benefits of its hard work in that year's accounts. Further, few pension schemes will have based their funding plans on the FRS17 assumptions. In most cases the trustees and employers of a scheme are now required to agree a set of assumptions which is uniquely appropriate to their scheme (known as the 'technical provisions' in the scheme-specific funding regime under the Pensions Act 2004). There will therefore usually be a divergence between the employer's balance sheet and the real level of funding in the scheme as agreed between the trustees and the employer.

To make matters worse, proposals from the Accounting Standards Board and the advent of Solvency II could lead to defined benefit pension liabilities having to be disclosed on an even more conservative basis in future. The Accounting Standards Board has suggested that a 'risk-free' discount rate should be used in company accounts. This would make no allowance for the possibility of pension scheme assets being exposed to investment risk in order to generate returns to meet the liabilities in future. If it were to be extended to private defined benefit pension schemes, then Solvency II would broadly require the reporting of defined benefit scheme funding to be based on the same sort of minimum capital requirements used by insurance companies. This would be significantly more onerous than the FRS17 assumptions based on AA corporate bonds. At the time of writing, the latest consultation paper from the European Commission suggests that it is unlikely that Solvency II will be extended in this way, but it is an area which employers will continue to view with concern.

In short, changes to the accounting requirements in the United Kingdom from 2001 raised the profile of pension scheme deficits with directors and have pushed the disclosed cost on the balance sheet much closer to the actual cost of buying out. The possibility of removing these liabilities from the balance sheet once and for all in return for a single premium payment thus became significantly more attractive.

2.3 Volatility in the equity and bond markets

Almost all UK pension schemes have some exposure to UK and overseas equities and bonds, and both the equity and bond markets can be volatile. They are vulnerable to high rates of corporate insolvency and 2008 saw this on an unprecedented scale. It seems fair to say that everyone was shocked by the performance of the equity and bond markets when the global financial crisis gripped the UK economy in 2008. As

a series of high-profile victims such as Northern Rock, HBOS, AIG, Lehman Brothers, Merrill Lynch and Bradford & Bingley sought assistance from third parties or the taxpayer, or simply became insolvent, every investor was reminded that no investment is absolutely safe and that past performance really is no guarantee of future performance.

However, it would be incorrect to suggest that short-term volatility in the equity or bonds markets automatically makes buying out pension liabilities more attractive. When volatility results in highs in the bond markets, it actually reduces the scheme liabilities on company balance sheets, since FRS 17 is linked to the yields on corporate bonds. Also, equities are generally accepted as being risky investments in the short term and a degree of short-term volatility is expected.

Buy-outs become more attractive because both falling asset values and poor returns on bonds will increase the funding deficit in a pension scheme. This in turn increases the demands on employers to pay higher contributions and makes it more expensive to run a scheme on a daily basis. Lower asset values and higher pension scheme deficits also affect company accounts and weaken the perceived financial position of the employers. In addition, when the bond markets are high, buy-out premiums can go down. All of this increases the attraction of a buy-out which will discharge the liabilities underlying those deficits once and for all.

Even so, the picture is not clear-cut and volatility can also make buy-outs less attractive (at least in the short term). Higher pension scheme deficits also mean that in order to finance the premium charged by the insurer or other buy-out provider, an employer may need to find more money to top up scheme funding.

2.4 The rise of trustee activism

In the period in question, a variety of factors – not least the increased awareness of the magnitude of pension scheme liabilities and the existence of the pensions regulator – led to increasing levels of trustee activism. More and more employers found that the trustees, sometimes in alliance with the trade unions representing the employees, were demanding greater security for the employees' pension benefits in case the employer should suffer a catastrophic event of some sort. The pensions regulator actively encouraged trustees to act as unsecured creditors (and still does). Increasing numbers of them took to demanding employer covenant reviews, the disclosure of financial information and greater clarity as to the directors' future business plans.

Pension scheme deficits are now such a high-profile issue for some employers that in many cases they can be a distraction from actually running the employer's core business. The cumulative cost in time and money of addressing appropriately the issues raised by active trustees can be very significant. At a rough estimate, three-quarters of UK defined benefit pension schemes are already closed to new joiners. In those cases, management time is being spent on historic liabilities which often relate to only a small number of the current employees (if any). The ongoing cost of dealing with such historic liabilities is one which can be offset, in the minds of the directors, against the premium charged by a buy-out provider.

2.5 The Pension Protection Levy

The principle behind the PPF, in simple terms, is that successful employers must pay for unsuccessful employers' pension scheme deficits. Those employers whose pension schemes would, if the employer were to suffer a qualifying insolvency event, be eligible to enter the PPF must pay the levy. The amount payable by each employer is substantially based on the potential insolvency risk which it represents and the funding deficits in its own defined benefit scheme. The levy payable by each employer is therefore tailored to its circumstances, to some degree. Nevertheless, it is an unwelcome additional burden in the short term and in the long term represents a significant risk as the PPF's capital requirements increase and the number of contributing employers shrinks. The levy offers no direct benefit to the employer paying it unless it becomes insolvent. The amount of the levy is another expense which can be offset against the buy-out premium by the employer, making that one-off payment more attractive.

2.6 Improvements in longevity

The key reason for the increase in the cost of providing pensions is that they must now be paid for longer. As with the other factors considered in this section, the direct result of improvements in the longevity of employees from an employer's point of view is higher contributions to meet the increase in the projected future cost of the pensions. In 1975 the rate of increase in life expectancy was around 0.75% per year. Between 2000 and 2008, the rate of increase has been closer to 4% per year,¹ and these increases force trustees to ask for higher and higher contributions. Further pressure comes from the pensions regulator, who indicated in a consultation paper in October 2008 that he would take particular interest in mortality assumptions when conducting his investigations.

The mortality tables produced by the Continuous Mortality Investigation, which try to anticipate future increases in life expectancy, have been updated in recent years, but the tables flatten out the mortality experience of the population as a whole and take a fairly conservative base case as their starting point. They are therefore inevitably inaccurate for any given scheme. Actuaries use these tables to advise trustees on what assumptions they should make about the future cost of pensions in order to determine how much the employer should contribute to the scheme. However, life expectancy depends on many different factors which affect different groups of people in different ways. An employee's job, salary, postcode and eating, drinking or smoking habits, as well as the amount of pension to be received on retirement, are all relevant in determining life expectancy. Even within a single city, life expectancies can vary greatly from one area to another.

The most accurate way to assess the likely mortality rates for the members of a particular scheme is to look at the actual mortality experience within the membership of that scheme, rather than the population of the country as a whole. Creating specific mortality tables for a scheme does require quite a large number of members to provide meaningful results; so only large schemes are likely to do so. In

1 Source: Paternoster – printed in “Guide to bulk annuities”, a Professional Pensions publication, June 2008.

most cases a buy-out provider will require as much evidence as possible relating to the scheme's specific mortality experience before determining the premium for buying out the scheme's liabilities. The attraction of passing this inherently uncertain expense to a buy-out provider can only have grown as the true rate of the increase in life expectancy has become clearer to employers and trustees.

2.7 The role of the press

Finally, in recent years pensions have become front-page news. There has been an exponential increase in the number of headlines concerning the sizeable funding deficits in both the public and private sectors. Headlines have also drawn attention to any employers that have tried to control their costs by terminating the accrual of defined benefit pension entitlements for future service or closing their defined benefit schemes to new joiners. The press has therefore raised public awareness of the very high cost to companies of providing defined benefit pensions and has, to some extent, contributed to the growth of the buy-out market by bringing the true scale of the problem to the attention of more employers.