



BUYOUT LIABILITIES During the summer, pension funds achieved surplus on FRS17. Subsequent stock market turmoil made that temporary, but this in turn brings home the need for a balanced strategy to remove defined benefit risks and the different approach required for exit strategies

Making a sharp exit



**TONY
READ**

Finance directors looking at their company's defined benefit (DB) liabilities may not think it, but the summer of this year brought some good news.

Research from Aon concluded that, for the first time since the FRS 17 accounting standard for pension schemes was introduced in June 2001, there was an aggregate UK pension surplus in DB schemes – quite a turnaround from a deficit of £50bn in the recent past.

This good news came about as a result of higher interest rates pushing up bond yields (which, in turn, reduced the cost of DB liabilities) and strong (although recently volatile) equity markets.

The return of the word 'surplus' has turned many employers' attention to exit strategies. Unfortunately, though, the good news on the FRS 17 front was not the end of the story, even before the

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subsequent stock market turmoil. To get to the next chapter, we need to explore the world of yield curves and mortality.

FRS 17 v buyout liabilities

FRS 17 values liabilities with reference to AA-rated corporate bond yields, both pre and post retirement. Meanwhile, the risk-free asset and traditional yardstick for a life office pricing annuities is a gilt yield curve, typically with an adjustment. So annuity pricing bases assume lower bond yields, and this is a key reason why buyout costs are higher than FRS 17 valuations.

A further important factor is the ever increasing longevity assumptions that need to be built into a prudent annuity pricing basis. For example, it is said that for every middle-aged man living in the UK, a man a day younger has an additional four hours of life expectancy. It is worth noting that a life company must typically use more conservative assumptions than a pension fund, as the payments they

will have to make are guaranteed.

Finally, add in a premium for the risk incurred, explicitly taken into account by a life office's capital requirements, and the typical buyout cost for a scheme may be 25% to 30% higher than FRS 17.

As any finance director will know, that kind of difference is a lot of money given the typical size of a DB scheme's liabilities.

So the good news, however temporary, is that UK DB schemes returned to surplus in aggregate earlier this year on an FRS 17 basis. As we have seen, this is only part of the story.

Innovative solutions

Any solution to help employers transfer their defined benefit liabilities off the balance sheet generally needs to address the problem of how to secure benefits. The alternative of carrying the risk within the scheme with no end in sight is not very attractive.

The size of this challenge is immense, and companies have responded. According to the

Pensions Universe risk profile (the Purple Book) from the Pension Protection Fund and the Pensions Regulator, only 31% of the 5,800 schemes in the survey covering £635bn of assets remain open to new entrants. Furthermore, an increasingly large proportion of schemes are closing to future accrual, even for existing members.

For most companies, it is unlikely there will be sufficient funds to buy annuities in one go – even though bond yields have risen – for the reasons we have seen. Therefore, careful planning over a number of years is required, taking into account complex variable factors. How can companies go about this?

A lot of innovative thought is being given to this issue in the marketplace, and there are now a number of solutions available.

For most such solutions, the starting point is usually to look at a scheme's liability profile and split it into tranches. For example, a paid-up scheme might have the following split, also illustrated graphically in the chart opposite:

- Buyout tranche 1 – pensioners above 60;
- Buyout tranche 2 – pensioners below 60;
- Buyout tranche 3 – deferreds above 50;
- Buyout tranche 4 – deferreds below 50.

Once this segmentation of liabilities has been done, the actuary and investment manager can start to plan the exit strategy for the employer. This can take many forms, and the following variations are available in the UK market today:

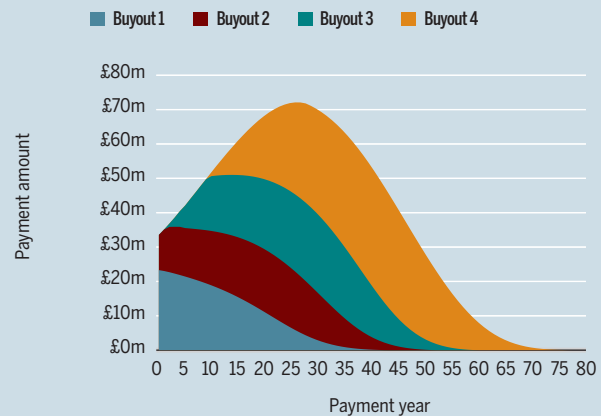
- buying tranches of annuities as and when employers/trustees feel the time is right, depending upon current pricing conditions;
- paying single premiums to a specialist third party to settle liabilities for a predetermined period, eg 10 years. After that period has ended, the employer either picks up the liability again or may decide to buy out those benefits on a pre-set guaranteed mortality basis;
- the employer or trustees may decide to self-insure one or more tranches for a set period, and at the end of that period pass the liability over to a life office by buying annuities.

A fascinating new development has been the pooling of asset

KEY STAT

4hrs
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SEGMENTING THE LIABILITIES



management and actuarial expertise between asset managers and life offices. For example, one such joint venture between UBS Global Asset Management and Aegon UK sets out an integrated solution that combines administration, asset/risk management and buyout of tranches of liabilities over a preset term.

Joined-up solutions such as this give the scheme a high degree of flexibility, plus a number of highly valuable benefits from the integration of the various elements:

- The life office will guarantee the annuity pricing basis for a number of years ahead;
- The asset manager will pursue an invested actively managed portfolio, optimally designed to reach the desired return. This would be achieved by exploiting stock-specific market and currency opportunities with a derivative overlay to remove unwanted market, interest rate and inflation risk;
- Furthermore, current yields need not be locked in, and parts of the yield curve that the asset manager views as being too low can be exploited. As yields rise, this can be used to benefit the scheme;
- More expensive segments of liability, typically the deferreds, can be left until later on in the process. This gives the asset manager the opportunity to add value in the meantime to assist with the buying out of these remaining segments.

For the employer, this means that asset management and risk management are specifically tailored to lead to buyout. This includes optimal risk budgeting and the opportunity to benefit from further rising interest rates.

Overall, this will reduce expected

contributions to reach full buyout. Furthermore, longevity risk is immediately reduced and eventually transferred to the life company. The end result is that the employer has exited from its DB liabilities and the members have their benefits secured with a life office.

In other words, the employer achieves the Holy Grail of knowing what the endgame is and having a high probability of achieving full buyout over a preset period of years at a lower expected cost than going to full buyout initially.

Reaping the benefits

Serious challenges remain for employers seeking to exit their DB liabilities. Higher bond yields have helped the FRS 17 position, but this is only part of the story. Nevertheless, increasingly imaginative solutions exist in the market, such as joint ventures between asset managers and life offices.

So finance directors of the future may get to enjoy the cumulative effect of all those four-hour additions to their life expectancy in retirement.

They will also have the added benefit of knowing that the effects of this on their pension have long since been adequately costed by an actuary somewhere, and dealt with in an affordable way. **PM**

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