BULK ANNUITIES

KEY PRODUCT FEATURES

The core duty of a trustee of a UK defined benefit occupational pension plan is to take all reasonable actions available to it to maximise the likelihood that the correct plan benefits are paid to the correct individuals, on time and usually for life.

Similarly, the key drivers for many sponsoring employers are to minimise the risk of unexpected calls for additional plan contributions and to minimise the risk of the plan generating an adverse accounting impact.

Purchasing a bulk annuity is the ultimate goal for many trustees and sponsoring employers with a view to eventually winding up the plan in a robust and tried-and-tested way.

THE ARGUMENTS FOR AND AGAINST USING BULK ANNUITIES TO SUPPORT A PLAN'S BENEFIT OBLIGATIONS

ADVANTAGES

Bulk annuities have the following key advantages relative to other products and strategies:

PERFECT MATCH

1. Bulk annuities are the only asset class that can provide cash flows that precisely match a defined benefit plan's benefits (for current, contingent, and deferred pensioners). Other investment products and strategies can offer good approximations, but only annuities are flexible enough to match a plan's exact benefit payments as and when they are due and for the life of the insured individuals — regardless of when those individuals retire and die and/or exercise options such as taking a cash lump sum or a transfer payment to another pension arrangement.

2. Bulk annuities are designed to pay the insured benefits at the agreed levels regardless of what happens to interest rates, price inflation (RPI and/or CPI), investment returns, future reinvestment rates, and longevity because annuities are designed to be a perfect hedge against all these risks. Annuities are the only asset class that does this.

DEFINITIONS

BULK ANNUITY

A bulk annuity is a long-term insured annuity policy, paying insured benefits for the lifetime of each individual covered. It is issued by regulated life insurance companies only.

BUY-IN

A buy-in is where a bulk annuity is purchased by a trustee and then held by that trustee as a plan investment for the longer term. Buy-ins are used to help manage a plan's risks, as set out in this paper. Many buy-ins are purchased with the intention of holding the bulk annuity for a number of years — with a longer-term intention to convert the buy-in to a buyout with the same insurer (and most likely at no extra cost) as part of winding up the plan in the future.

Buy-ins are often purchased in respect of a defined subset of a plan's overall membership — for example, current pensioners in payment only. In some cases, a buy-in in respect of a subset of a plan's members may actually increase the level of overall risk borne by the plan and its sponsoring employer, depending on which existing plan assets are used to purchase the buy-in. It is important to carry out plan-specific risk-impact analysis in this regard to understand the true impact.

BUYOUT

A buyout is where a bulk annuity, held initially as a buy-in, is split into a series of personal annuities granted to individual plan members in lieu of further plan benefits, usually as part of a plan wind-up.

ENHANCED SECURITY

3. Bulk annuities are a recognised route, supported by UK legislation, for a trustee and sponsoring employer to wind up a pension plan by transferring responsibility for payment of the plan's benefits to the insurer issuing the annuity and without requiring each individual's consent.

4. Bulk annuities are long-term insurance policies provided by life insurers:

a. Insurers active in the UK bulk annuity market are authorised by the Prudential Regulation Authority (PRA) and regulated by the Financial Conduct Authority and PRA. The strength of the reserves that insurers are consequently required to hold means that they offer their policyholders a financial covenant that is very strong relative to that offered by many (perhaps most) pension plans and their sponsoring employers.

The PRA imposes solvency rules for insurers that are much stricter than for pension plans. At all times, insurers must hold assets with a market value significantly higher than the liability value of the annuities on a prudent basis set by the PRA. That is, insurers must be more than 100% solvent at all times, unlike pension plans, which are allowed to have significant deficits (albeit with an agreed deficit reduction plan in place with the sponsoring employer). Insurers wishing to hold assets with volatile market values such as equities must compensate by holding more spare capital. This is the opposite of pension plans, where holding equities often reduces the assessed/perceived value of liabilities and hence reduces contributions and reserves that are required. There are also limitations on the amount of reserves an insurer can hold in asset classes that do not clearly hedge the risks borne by the insurer.

b. Annuity holders are expected to be protected by the Financial Services Compensation Scheme, the UK's statutory safety net for the insurance and banking industry. In essence, the scheme is designed to support the continuation of insured benefits at the 90% level if the insurer's financial health falls below strict minimum standards. No other major asset class has this type of statutory protection.

c. There are other layers of comfort as well. The PRA monitors each insurer on a regular, ongoing basis. In the event that an insurer is struggling to meet its capital requirements, the PRA will intervene and likely prevent the insurer from selling new business as the first step to improve the insurer's finances. Some insurers have other (non-life) insurance businesses and/or parent companies who can step in to provide financial assistance if needed. In the event that none of these measures proves adequate, the PRA will try and arrange a transfer of the business to another insurer so that policyholders continue to be paid in full.

EXPERIENCE AND FOCUS

5. Bulk annuities are offered by a range of insurers, some of which are FTSE 100-listed companies and have well-known brands in the UK, such as Aviva, Legal & General, and Prudential. Other insurers are backed by large institutions and/or have large overseas parents. Most of the active insurers have extensive annuity experience acquired over many years. Bulk

annuities have been offered continuously in the UK since 1986, initially meeting the needs of insolvent pension plans needing to purchase annuities in order to wind up. Purchasing a bulk annuity is a well-trodden path, with many hundreds of trustee boards and sponsoring employers having purchased bulk annuities to date.

6. The insurance environment is specifically designed for, and focused on, paying pensions and related benefits:

a. Insurers maintain a strong financial management discipline, as described above, and they have dedicated administration systems and processes because this is their business.

b. Most insurers manage multibillion-pound investment portfolios backing their annuities. Purchasing a bulk annuity in effect grants you access to investment expertise and risk-management strategies that you might not otherwise be able to access.

c. By contrast, most sponsoring employers would ideally prefer to focus on managing their business interests rather than managing their pension plans. Over the years, many pension plans have grown in size and now require often significant financial and human resources to maintain the plans in line with legal and commercial requirements.

PRODUCT DESIGN

7. All features of a bulk annuity are bundled into one package governed by one (usually bespoke) policy. The purchase price of a bulk annuity includes all future investment management charges and insurers will also include member administration services if required — meaning that bulk annuities really can be a one-stop shop.

8. The bespoke nature of a bulk annuity means that many and varied additional elements can be included as required, such as cover for overlooked beneficiaries, cover for incorrect benefits and/or member data, and cover for regulatory issues. An example is cover for “equalising” guaranteed minimum pensions. Moreover, the market continues to be innovative, meaning that it is often possible to design a product that meets the particular needs of the sponsor and trustee. This means that a bulk annuity can form the foundation for a comprehensive transfer of a plan’s benefit obligations to one or more insurers, allowing the plan then to be wound up on a robust basis.

ACCOUNTING

9. If a bulk annuity is purchased and held as a long-term plan asset, Mercer and most auditing firms agree that it is unlikely to be accounted for as a settlement under the international and UK accounting standards. Opinion is more divided on the treatment under US accounting standards, with some bulk annuities held as long-term plan assets being accounted for as a settlement while others are not. However, you should take advice specific to your circumstances.

MERCER

TALENT • HEALTH • RETIREMENT • INVESTMENTS

DISADVANTAGES

As with any product or strategy, bulk annuities do have disadvantages — some potentially significant — relative to other products and strategies that might be available at a given time. Bulk annuities are not suitable for all trustees and sponsoring employers.

The key disadvantages of annuities relative to other products and strategies are likely to be:

FINANCIAL

1. The long-term and comprehensive nature of the "benefit promise" afforded by an annuity and the strong financial covenant of an insurer supporting the annuity means a bulk annuity may be viewed as "expensive", not least as the premium can often be significantly more than the market value of a plan's existing assets. Many trustees and sponsoring employers find that annuities covering a plan's full benefit obligations are unaffordable at a given point in time and that a strategy is required to put the trustee into a position in the future where it can afford a bulk annuity.

2. Bulk annuities are intended to make the issuing insurer a profit in the longer run. This profit margin represents an additional cost, over and above the cost of providing the plan's benefits.

3. The number and hence choice of insurers willing to bid for a plan's business at a point in time may be small relative to the bidders and choice available with regard to other asset classes. Many trustees and sponsoring employers will find around five insurers are willing to bid for their business. Some trustees and sponsoring employers will find that only two or three insurers will be interested in selling the plan a bulk annuity (and on rare occasions there may be only one insurer interested). Nevertheless, in virtually all cases, insurers compete aggressively and a robust competitive tender process can be undertaken.

INFLEXIBILITY/RISK

4. Bulk annuities can rarely be surrendered and so purchasing one is an irreversible decision — removing the potential for future opportunistic investment and hence potentially increasing overall costs for the sponsoring employer.

5. Bulk annuities are, by design, bespoke for a given plan and therefore a detailed legal contract needs to be negotiated and agreed in advance. It usually takes between three and six weeks from the initial decision to proceed with an insurer to the date the insurer then goes on risk.

6. There can be situations where the sponsoring employer is perceived to be a stronger counterparty than most/all insurers, hence potentially removing the need to purchase a bulk annuity and pay an insurer its profit margin.

7. Engaging with any counterparty, including insurers, generates the risk that the counterparty defaults on the agreement. Several of the items described above mitigate this risk, arguably to a large extent. But it remains true that a bulk annuity represents a concentration of investment risk with one counterparty.

TO FIND OUT MORE

Please contact your usual Mercer consultant or one of the following specialists if you wish to discuss the information in this paper.

David Ellis
E: david.ellis@mercer.com
T: 0113 394 7591

Akash Rooprai
E: akash.rooprai@mercer.com
T: 020 7178 3107

Harry Harper
E: harry.s.harper@mercer.com
T: 0161 837 6623

12110-RE 040613