QUANTUM ADVISORY
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RISK TRANSFER JOURNEY PLANNER

Q2 | 2022

Buy-out and other endgame options

Welcome to Quantum Advisory's Q2 2022 risk transfer journey planner. Each quarter, our risk transfer team will bring you details of market pricing and industry developments in relation to buy-ins, buy-outs and consolidation vehicles. We tackle all the big risk transfer issues and share the insight and knowledge we use to manage each pension scheme on the journey towards their end game.

IN THIS ISSUE

Pensioner Buy-out & Buy-in pricing

This note gives an update on pricing for pension schemes looking to buy bulk annuities for pensioners. This could be as a buy-in (where the members remain in the scheme) or a buy-out (where the members leave the scheme and are paid directly by the insurer).

Overview of insurer pricing

Insurers price business based on gilt and corporate bond yields, plus the cost of setting aside regulatory capital, their desire for new business and how well any particular scheme would fit with their existing portfolio. This means there is no one figure for the buy-out cost for a pension scheme. However, we receive monthly data from a number of insurers which allows us to monitor how pricing moves over time.

Market background – financial drivers

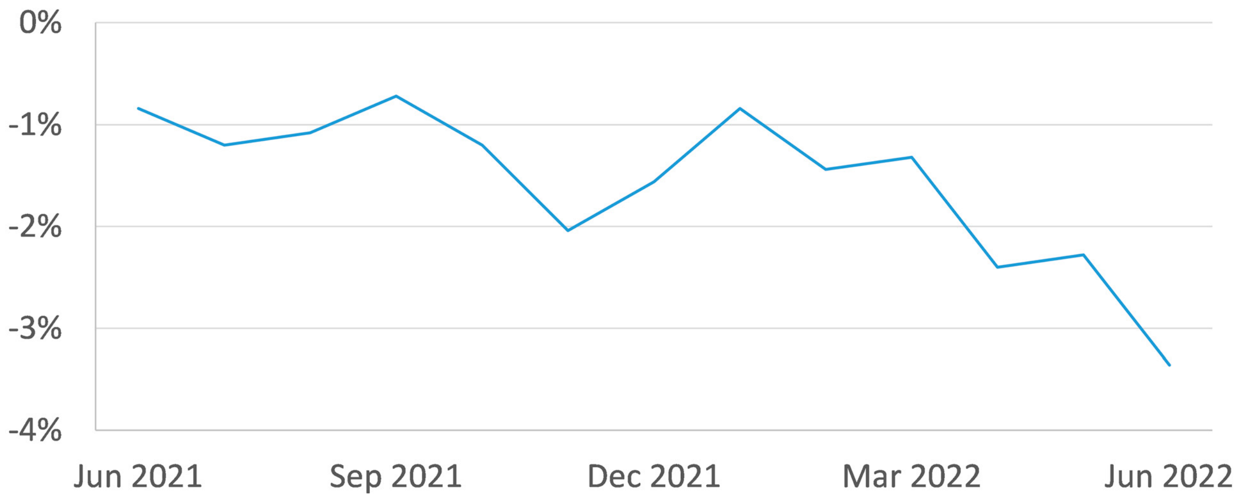
Markets remained volatile in Q2 2022, and both gilt and corporate bond yields rose significantly by around 0.9% - 1.1% pa (and continue to rally into quarter 3. Market implied inflation fell by around 0.5% pa. The net impact was lower insurer pricing for all benefits, but especially benefits with inflation linkage. This can be seen on the chart overleaf.

On the asset side, both equities and bonds ended the quarter at a lower level than they started (although there was some recovery in quarter 3). The impact on individual schemes will depend on their asset allocation, but almost all schemes will have seen falls in asset values.

Pricing update and de-risking opportunities

The chart below shows that insurer pricing relative to gilts has become more attractive over the last year (and particularly over Quarter 2). (shown by the downward-sloping line). Buy-ins for pensioners are available at around 3 - 4% less than the cost of funding the same benefits with a portfolio of gilts.

Pensioner buy-out pricing relative to gilts



A pension scheme looking to buy bulk annuities as a cash buyer will see this pricing as more attractive than a year ago because prices have also come down in absolute terms.

The difference between liabilities on a gilts basis and the buy-in/buy-out cost offers an opportunity for schemes with a large proportion of gilts backing their pensioner liabilities to reduce risk for little, if any, cost.

Pricing for deferred members remains higher than for pensioners because of the additional risk they represent to an insurer. A scheme looking to sell gilts to fund a deferred member buy-in would still need to find an additional c10% on top of the value of the gilts.

The buy-in process

Transacting a buy-in will usually take a few months, but there are steps you can take to plan ahead and speed this up. These include:

- Ensuring that all scheme documentation is in good shape, including common sticking points such as Barber benefit equalisation.
- Ensuring that your membership data is complete and accurate.
- Reconciling GMPs with HMRC (which should be in progress now that HMRC have issued final data).
- Equalising GMPs for differences between male and female benefits (now confirmed to be required by the Lloyds judgement).
- Consider your investment strategy and whether any additional de-risking, relative to buy-in pricing, should be implemented to reduce volaility and risk.

Any schemes considering buying bulk annuities should be aware that insurer capacity will ultimately be limited by availability of assets and re-insurance. The steps above will help in showing insurers that you are serious when seeking quotes.

We can assist with planning for a buy-in if you are considering this route.

Next steps

Prices vary both between insurers and over time, so a full quote is the only way to obtain accurate pricing. If you would like more information, please speak to your usual Quantum contact.

Spotlight on a DB pension solution - Clara Pensions

In this issue we interview Ashu Bhargava, Chief Origination Officer at Clara Pensions. Clara is a 'member first' solution for defined benefit pension schemes where there is a desire for separation from the sponsor, whilst still maintaining the promise of full benefits to members.

Briefly explain, what is your product and what are its main benefits to trustees and sponsors?

We're a new option available to trustees and sponsors, who cannot afford buy-out, but would like to fulfil their pension commitments now and offer members greater security.

We are a bridge to an insured buy-out. No profit or capital is extracted until each member's benefits are fully secured.

Clara provides members with a safer pension promise by combining its own capital and governance with additional sponsor contribution. Sponsors having transferred pension liabilities to Clara, can focus on their future growth. Our model of sectionalisation means the assets and members that transfer to us become their own section supported by its own funded capital.

What type of scheme do you feel your product is best suited to?

While Clara won't be right for every scheme, we're seeing interest from three key groups:

1. Well-funded schemes with a weak or at-risk sponsor - trustees want to remove the risk of the insolvency of the existing sponsor triggering wind-up and reduced members' benefits;
2. Schemes exiting PPF assessment – rather than securing reduced benefits with an insurer, a transfer to Clara can provide members with full benefits;
3. M&A/ corporate restructuring - these are contingent on settlement of the pension scheme. Based on the insurer cost, corporate activity is economically unviable, but is economically viable, in conjunction with a settlement of the scheme with Clara.

Name the three biggest obstacles to achieving a successful transaction?

As is the case for bulk annuity transactions incorrect member data, incorrect benefit specifications and a lack of infrastructure to seize market opportunities.

What are your targets over the next 12 months? 5 years?

Having now received tPR approval, the focus for Clara is on completing our first transactions. We have a strong pipeline and hope to achieve this milestone later this year.

Clara remains on track to consolidate £5 billion in liabilities by 2025, if not sooner, thanks to the interest we have seen.

What do you see as your biggest challenges?

When Clara entered the market, DB consolidation was a new concept. As such, healthy scepticism was only natural. However, tPR's robust regime gives members, trustees and sponsors confidence that Clara is a secure option. We're seeing this reflected in our healthy pipeline.

All transfers to Clara must be Cleared by tPR. Trustees and sponsors have taken comfort that (i) a proportionate approach having regard for the circumstances of the scheme can be adopted; and (ii) early engagement with tPR is encouraged, which means tPR input on any proposed approach can be obtained at an early stage.

What do you see as the future for small <£50m schemes?

Clara is open to schemes of all sizes. With the level of interest in our model surpassing initial expectations, we're currently focusing on larger schemes, primarily those over £200m in liabilities. Once we've completed our initial transactions we will aim to implement a streamlined process as quickly as we can to facilitate transfers of small schemes to Clara.

Quantum's view

We see the development of the consolidator market as a positive step for the industry. We have been actively engaged with clients for whom Clara may be an appropriate option to help them understand whether this is the right pathway for them. We continue to discuss all market options with clients on an ongoing basis to ensure trustees can make informed decisions, which are right for their scheme and members."

Clara
PENSIONS

Quantum Advisory case study

Helping trustees navigate the challenges of a buy-out of a small scheme - Large transportation and logistics business

Introduction

Small scheme buy-outs can be challenging as the number of insurers willing to quote at that end of the market is often limited, meaning that pricing may not always be as competitive as for larger schemes. Here we examine a case study for one such small scheme.

Background

A long-standing client of Quantum Advisory has a number of pension schemes that we advise. As well as ongoing Defined Benefit (DB) and Defined Contribution (DC) arrangements, there was an old legacy Executive DB scheme that had been closed to active members for many years.

We had worked closely with the Trustees on their funding and investment strategy to improve the funding level of the scheme with the long term aim of buying out the members' benefits with an insurer and ultimately winding up the pension scheme.

When we determined that the funding level had improved sufficiently the scheme would now be able to afford a buy-out without a contribution from the sponsor and therefore advised the client that a buy-out project could commence. The scheme had assets of around £25m and 50 members with bespoke benefits for a number of members due to the historic development of the scheme's benefit structure.

Preparation work

The first stage of the project was to provide the Trustees with suitable training to ensure that they were comfortable with what a buy-out entailed and the process that the scheme would need to go through. We then produced an indicative project plan and worked closely with the scheme's legal advisers to set out of the steps that would be completed.

As with any buy-out, the initial focus is on the scheme's data and the governing documentation – it is key to identify any potential issues as soon as possible in a buy-out project and these are two areas where challenges can often arise. This is particularly important for smaller schemes, which can be viewed as less attractive than larger schemes by the insurers in the market. There are two elements to the scheme's data.

- Firstly, it was important that all data held on the administration systems are accurate and reliable and, with regular monitoring and data quality assessments, this step could easily be achieved for the scheme.
- Secondly, insurers require more data than a third-party administrator would typically hold. For this scheme, information on members' spouses and dependents was not previously held; a communication exercise with the members to obtain any missing data was conducted.

Approaching the market

Once the data and scheme documentation were in good order, we approached the market with a request for quotations. For smaller schemes such as this one, there are typically fewer insurers who are interested in quoting, however the preparation work completed by Quantum Advisory for the scheme ensured that it was attractive to insurers – i.e. there were no hidden surprises and a transaction was achievable relatively quickly.

In the end, we were able to obtain very competitive quotes from two leading providers with the final premium resulting in a saving of approximately 10% from the initial buy-out cost estimate. With an excellent price achieved, we worked swiftly with the Trustees and their other advisers to complete the buy-in transaction.

Finalsing the buy-out

With the initial buy-in phase complete, the scheme had transferred all of its risks to the insurer with the attractive premium leading to a small surplus remaining in the scheme. Over the next few months, we worked closely with the insurer to validate the scheme data and ultimately handover the ongoing administration and payroll of the scheme. At the same time, we worked with the Trustees and sponsor to refund the remaining surplus assets to the employer.

Once everything was in order, the buy-in policy was converted to a buy-out and the members of the scheme issued with individual policies from the insurer. All the liabilities of the scheme had now been discharged and the scheme could then be wound up.

The project had now been completed on time, within budget and with a positive outcome for all parties involved.

Conclusion

For any scheme looking to buy-out in the near future, and particularly for smaller schemes, the main takeaway for trustees is that preparation is key. By ensuring that scheme data is accurate, governing documentation is up to date and there are no nasty hidden surprises, small schemes can achieve a successful buy-out.

This quarter's buy-out preparation tip

Preparing a scheme for buy-out is an essential step on the way to securing member benefits with an insurer or consolidator vehicle. Even if you are not considering buy-out now, advance planning and methodical action are critical in ensuring that the key tasks are given due care and attention usually leading to a smoother and more efficient buy-out process.

There are a number of steps needed to prepare a scheme for buy-out. Each quarter we will give you tips based on recent experiences which we hope will help you tackle your exercise.

This quarter we focus on...

Preparing your legal documentation

Compliance

This initial step is designed to uncover any unforeseen problems in the scheme's trust deed and rules.

Your legal adviser will need to review your entire suite of scheme rules to ensure they agree with historic administration practices, particularly for old deferred and pensioner members who may have left the scheme over 20 years ago!

It is not uncommon for important historic legal documents to be missing, incomplete, or for errors to be found in their execution. Important matters such as equalisation, or cessation of accrual might need to be addressed again, which could impact the cost of premium and the timescale to achieve buy-out.

Identifying these problems before the critical stages will help your buy-out run smoothly.

Discretion

Another important reason to review your rules is so they can be rationalised to enable an insurer to easily administer the scheme post buyout.

Most scheme rules will allow certain employer or trustee discretions or require consent for certain actions. Good examples of this are the awarding of discretionary pension increases for certain tranches of benefit and early retirement consents.

These areas of the rules will need to be reviewed and decisions made before quotations are sought so the bulk annuity policy can be priced on consistent terms. Sometimes rule changes are required too.

Simplification

We often encounter benefit structures that can be readily administered on an ongoing basis but which are undesirable or uninsurable from a buy-out perspective.

Examples of this include Normal Retirement Ages that follow State Pension Age, Longevity Adjustment Factors that adjust a member's benefit entitlement based on shifts in life expectancy and application of defined benefit or defined contribution underpins for certain benefit tranches.

Getting an early legal review and taking proactive steps to amend rules and crystalise entitlements early on in the process will mean indicative costings provided by the actuary or quotations given by insurers will be more accurate and representative of your true buy-out cost.

Quantum's risk transfer team

At Quantum Advisory we have a dedicated team of senior actuaries and investment consultants helping to advise on and implement all types of risk transfer strategies, from liability management exercises, to buy-ins, buyouts and consolidation vehicle transfers. Our experience has been built up over many years both within Quantum Advisory and while working at other leading pension consultancies, so there are few issues we have not collectively encountered and overcome.

This quarter's edition was prepared by Adam Cottrell. Adam is a key member of the Risk Transfer team at Quantum Advisory, leading our research and engagement with the major consolidators and master trust vehicles as well as project managing, delivering advice and preparing schemes for traditional insurer buy-out exercises.

He is also a member of Quantum's Multi-Employer and Public Service Pensions team, focusing on helping employers manage the ongoing risks and costs associated with their multi-employer schemes, including LGPS, SHPS and Teachers Pension Schemes, and advising on and implementing admission agreements and cost effective exit strategies.

Adam is a qualified Actuary with more than ten years of experience providing actuarial, strategic pension consulting and other specialist pension advice to trustees and sponsoring employers of UK pension schemes. He enjoys all things football, has a particular passion for food and drink and is glad to see an increasing focus on the social impact side of ESG within corporate decision making.

Quantum has offices in Amersham, Birmingham, Bristol, Cardiff and London. Give us a call to see how we can help with your risk transfer, pension and employee benefit challenges.

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Quantum Advisory

Established in 2000, Quantum Advisory is an independent financial services consultancy that provides solution based pensions and employee benefit services to employers, scheme trustees and members.

We design, maintain and review pension schemes and related employee benefits so that they operate efficiently and effectively and are valued by employees. This means that you can get on with doing the things that you do best, therefore saving you time and money.

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