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RISK TRANSFER JOURNEY PLANNER

Q2 | 2023

Buy-out and other endgame options

Welcome to Quantum Advisory's Q2 2023 Journey Plan newsletter. Each quarter, our risk transfer team will bring you details of market pricing in relation to various risk transfer options as well as sharing useful tips and experience to ensure that your risk transfer journey is as smooth as possible.

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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 in Q1 2023 were much more stable than in the previous quarter, with gilt yields falling by about 0.2% and market implied inflation remaining broadly level. The net impact was higher insurer pricing for most benefits.

On the asset side, equities generally ended the quarter at a higher level than they started at, with bond prices ending slightly lower than where they started. The impact on individual schemes will depend on their asset allocation.

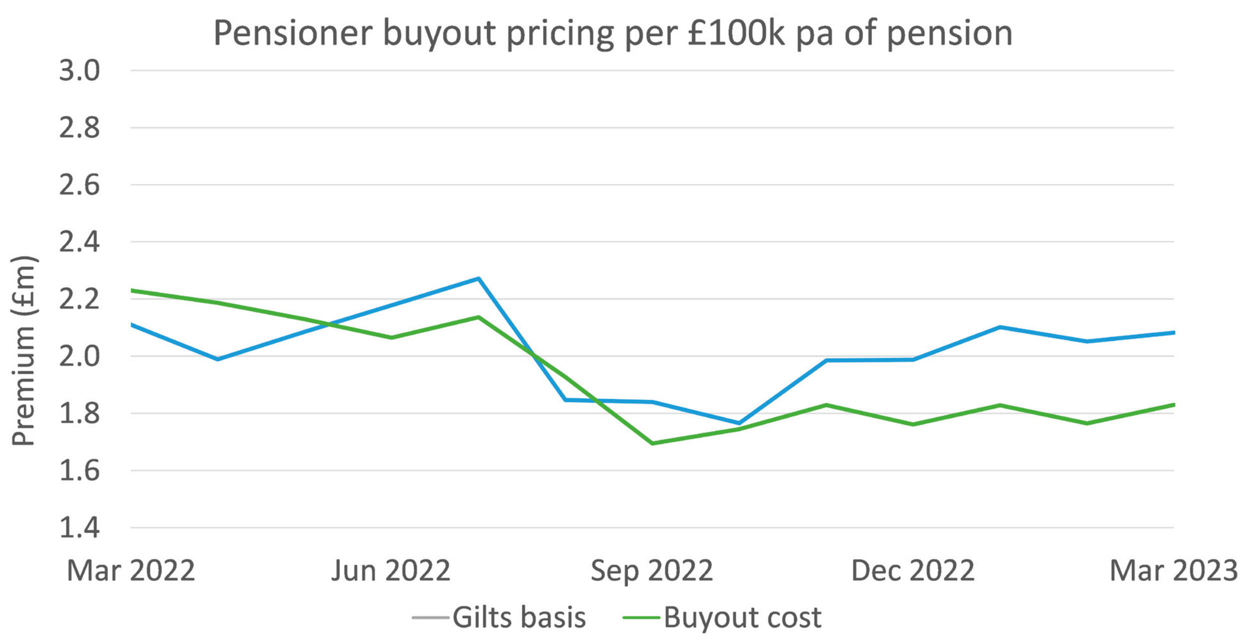
Pricing update and de-risking opportunities

The chart below shows that insurer pricing remains just slightly cheaper than gilts (shown by the green line sitting below the blue line). Buy-ins for pensioners are available at around 5-10% less than the cost of funding the same benefits with a portfolio of 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 come down materially 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 risks they represent for 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).

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.

The Interview: Teneo

In this issue we interview Harry Morgan and Tom Williams, Directors in Teneo's Pensions Advisory team with many years' experience undertaking buy-in provider reviews. Teneo is a leading multiservice, independent advisory firm, which includes advising trustees and corporates on all employer covenant and pension restructuring matters.

Harry Morgan

Harry has extensive experience providing employer covenant and restructuring advice to the stakeholders of defined benefit pension schemes across many sectors.

Tom Williams

Tom advises pension trustees, corporates and lenders on employer covenant in a scheme valuation context, and across a range of restructuring and transaction scenarios.

Why should trustees consider a covenant review of an insurer?

Understandably, this is a common question given the apparent strength of an insurer and the established view that buy-out is the gold-standard end-game solution.

The decision to buy-in and select an insurer is one of the most important decisions trustees make. Upon the final buy-out, the covenant of the employer is substituted for that of the insurer. Understanding this fundamental change is critical in making informed decisions, ensuring members' benefits are protected and evidencing that due consideration has been given.

Consequently, we are seeing increasing numbers of trustees commission insurer reviews.

How do you help trustees prepare for a buy-in transaction?

Our advice is always tailored to the specific circumstances, and can include:

- "Lighter-touch" review of insurers, with an explanation of the differences in regulatory environment and member protections. This is suited to schemes with less strong covenants.
- More detailed review, including comparison to the current covenant strength and ESG considerations. Typically, this approach is favoured by trustees of schemes with stronger existing covenants where the decision is more balanced.
- Benchmarking different insurers.
- Covenant monitoring of the insurer during the period between buy-in and full buy-out.

The Interview: Teneo

What will your review consider?

Our reviews are concentrated on the legal entity; underwriting the insurance, which represents the principal focus from a covenant strength perspective. Nonetheless, considering the position of the wider group and the support it could provide is also relevant.

In assessing this entity's financial position and risk profile, understanding its regulatory capital position and liquidity is key, including how this compares to its regulatory requirements, internal targets and market expectations.

Assessing performance of an insurer based on profits disclosed in its statutory accounts must be treated with caution. Complex accounting adjustments may not fully reflect underlying performance. Interpreting an insurer's financial reports requires skill and experience.

Trustees will wish to understand the position in the event the insurer encounters financial difficulty – including understanding how financial health may be restored or, in a worst-case scenario, the protection to members via the Financial Services Compensation Scheme (and how this compares to PPF compensation levels). Input from our specialist insurance restructuring team ensures the latest technical and regulatory developments are reflected in our work.

How do you compare this to the covenant of the Sponsoring Employer?

A conventional comparison of financial metrics is a helpful start point. However, this usually does not give the full picture given the insurer is likely to be a very different business to the existing employer, with a different capital structure, regulatory environment and risk profile.

Financial analysis needs to be carefully overlaid with qualitative considerations, including a reflection of the principles of the insurer regulatory regime to inform views around downside scenarios. Together, this provides a platform to consider covenant strength using TPR's four-point rating scale and the principles set out in the draft Funding Code, which can then be more easily compared to the existing employer's covenant rating.

What are your views on the impact of the forthcoming changes to the insurer's Solvency II regime?

Although the implementation timetable remains uncertain, the important changes will need to feature in any financial assessment of an insurer. The Bank of England estimates the relaxation in regulatory requirements (due to the reduction in risk margin) could increase the probability of life-insurer failure by 20%. It remains to be seen whether there will be a recalibration in requirements, or market expectations, in response. In any event, we would expect well capitalised insurers to remain resilient to market shocks.

Quantum's view

The purchase of a buy-in policy is typically a one-off purchase for pension scheme trustees. The selection of an insurer is therefore an important decision and we are increasingly seeing clients wishing to consider the strength of the insurer in some detail, as well as factors such as the quality of the administration service of the insurer, and ESG factors in the insurer's investment strategy.

A recent buy-in case study regarding S.A. Brain & Company Limited

In March 2023, the following press release was issued, revealing details of a £70m full scheme buy-in for S.A. Brain & Company Limited's pension schemes. Quantum Advisory was the transaction adviser.

Just Group has completed a £70 million full scheme buy-in with the Trustee of the SA Brain and Company Limited Group Pension Scheme and the Crown Buckley Limited Pension Scheme, insuring the benefits of around 420 pensioners and 200 deferred members. The transaction provides improved benefit security to members and delivers a key step in the Schemes' employer, S.A. Brain & Co Limited's, restructuring plan following the significant challenges encountered during the Covid-19 pandemic

After much work and due diligence, the Trustee signed a contract with Just Group to insure benefits for all members of the Scheme.

The lead transaction adviser, investment adviser and Scheme Actuary were Quantum Advisory. The Trustee legal advisers were Gowling, and Isio acted as actuarial adviser to S.A. Brain. The Trustee was chaired by Independent Governance Group (IGG).

Andrea Collins, Head of Trustee Relationships, DB Solutions at Just Group, said:

> *"Working closely with the Trustee, sponsor and advisors enabled us to successfully complete this transaction under short timescales. We were very pleased to be able to support the Trustees to achieve a positive outcome for the members."*

Jon Bridge, CEO at S.A. Brain & Co Limited, said:

> *"I am delighted that S.A. Brain was able to support the Pension Trustees and Just Group in completing this transaction. The executive team at Brains and the Pension Trustees at IGG have worked diligently together over an extended period of time with the shared aim of securing members benefits. Just have been fabulous to work with and I would like to thank all the advisors involved for all of their dedication and hard work."*

Tegs Harding, Independent Governance Group, Chair of Trustee, said:

> *"We are very grateful for the significant support from S.A. Brain, as well as positive engagement with Just who went above and beyond in this transaction to help us secure members benefits. I'm absolutely delighted that we have been able to deliver this outcome for members."*

Stuart Price, Partner at Quantum Advisory, said:

> *"We have enjoyed a long-term relationship with S.A. Brain so it is extremely pleasing that the team at Quantum could play an important part in fully securing the benefits promised to members of both schemes. To complete this transaction successfully in such a short timescale owed much to the great collaboration and hard work from all parties involved."*

The transaction was completed in December 2022.

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This quarter's buy-out preparation tip : Buy-outs for DC Schemes

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 DC pension schemes in the early stages of buy-out preparation.

Where a DC scheme includes pensioners, it should be straightforward to assign any annuity policies in the name of the trustees to the members. However, considerably more time needs to be allowed to deal with pensioners in drawdown, or who are taking a series of lump sums, if the scheme allows these options.

While these members might have originally chosen to take their benefits flexibly, buy-out is an opportunity for them to review that decision and they may feel that the time is right to annuitise, or take their remaining funds as a lump sum.

Given the range of different options available to such members, the trustees should ensure their member communications are clear and cover the options available to the members. The trustees may also direct them to seek independent financial advice. In fact, we have seen some schemes and sponsors meet the costs of setting up initial meetings with an independent financial adviser to ensure members receive bespoke advice aligned with their personal circumstances.

The trustees will need to give due consideration to the options for these members, which could be a transfer to a new provider, rather than a buy-in policy along with the active and deferred members, assuming that the receiving scheme is able to accept them.

We have DC specialists able to assist trustees to understand the options for members and prepare bespoke communications for members, clearly setting out appropriate options.

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. We can advise on liability management exercises, buy-ins, buy-outs, 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 Robin Dargie, Senior Consultant at Quantum Advisory.

Robin graduated from Cardiff University in 1988 with a degree in Economics and joined Quantum in 2004, having previously worked for Hewitt Bacon & Woodrow.

As a member of the risk transfer team, Robin leads our DC work, which can also include assigning AVCs for DB schemes and member communications. His expertise allows us to find pragmatic and often innovative solutions for members with DC benefits.

Robin has over 30 years' experience in pensions, consulting and administration of both Defined Benefit and Defined Contribution occupation pension schemes.

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Quantum has offices in Amersham, Birmingham, Cardiff and London. Get in touch to see how we can help with your risk transfer, pension and employee benefit challenges.

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

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

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