CARTWRIGHT
PENSION TRUSTS

Pension Scheme Insurance Deliberations – Are you Being Paid to Wait?

There's been a lot of talk in the industry lately on the prospect of UK pension schemes being encouraged to 'run on'. This is instead of insuring away their liabilities through the purchase of bulk purchase annuity insurance contracts (BPA).

Let's take a step back and look at the bigger picture, noting an implicit conflict of interest affecting the providers and advisers involved.

Why insure?

Sponsors are often tired of increasing costs and contributions, as well as balance sheet volatility unrelated to core operations.

Buying bulk annuities can be costly and potentially leaves value on the table. Furthermore, the pricing structure of insurers is opaque, making it hard to challenge or negotiate prices, particular for smaller schemes.

There can also be a commercial desire and potential pressure from sponsors to 'get a deal done'.

Trustees play a crucial role in ensuring value for members while balancing the needs of other stakeholders.

What drives the pricing of bulk annuities?

Fundamentally, pricing is based on:

- yields on liability-matched duration assets held by insurers:
  - market-risk free rates
  - credit spreads
- the insurance premium on top, which soaks up:
  - cost of reinsurance (especially for longevity risk)
  - ongoing running costs (impacted by limited number of qualified professionals)
  - insurer profits (impacted by appetite for new business)

Additionally, and perhaps not as often acknowledged, is that insurers also typically benefit over the lifetime of a BPA contract. This can be material (late teens to low 30s % return on capital). As such, there is a queue of capital waiting to back existing and new insurance providers.

The mechanics of the transaction and obscured insurer profits

Trustees hand over liabilities and assets (broadly equivalent to government bonds backing the liabilities) to an insurer. The insurer then purchases (cheaper) investment-grade credit securities. This provides the insurer with an upside of the annual credit spread, on top of their quoted premiums.

This additional profit is released over time to the insurer. And, although hard to predict, could be as high as 10% of the assets.

Recently-announced regulatory changes may impact insurers' ability to generate increased profits from their underlying assets. This may pass through to pricing over time.

The significant returns for bulk annuity providers might lead to buyer's remorse, if pricing drops or alternative solutions emerge.

Why some schemes might consider running-on

Larger schemes might consider running-on in a self-sufficient manner to benefit from the somewhat unclear upside of extra money. The question then is who should receive this benefit – sponsors (and therefore the government through surplus taxation), members, or both?

Our clients

Many of Cartwright's clients have benefited from insuring their pension schemes and providing ongoing member security. They now focus on the member experience and benefit from our data cleaning and ongoing high-quality administration as well as tightly managed project management and execution of their deals by an experienced senior team.

For smaller schemes, insuring still makes sense, but it's not always appropriate for everyone. Schemes and sponsors will want to see a financial benefit from delaying execution that outweighs the costs of running on. This includes all legal, actuarial, investment advisory, asset management, trustee and other ongoing costs.

As a rule of thumb only, schemes below £100m, that are in a position to insure, will likely have less incentive to run-on given the size of their fixed operational costs.

What does this mean for you?

In both corporate and pension trustee boardrooms there is sometimes a reticence to 'be the first' or step out of line with what peers are doing. But, given the importance of getting this right, we believe it could, for many suitably invested schemes, pay to be patient.

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This leads to the need for considerations around how to invest in the final years approaching a decision point. This is likely to keep trustees of such schemes busy over the coming years.

Again, we would highlight the potential for conflicts of interest. It should be openly acknowledged that it is not just trustees themselves but the ecosystem of advisers too, who might wish to continue their roles into the future, or execute lucrative transactions.

We're closely monitoring market innovations and are here to discuss this topic further.

If you'd like to discuss any of these matters further, please get it touch with your usual contact at Cartwright.

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