Investment opportunities
Locking the potential of future benefits

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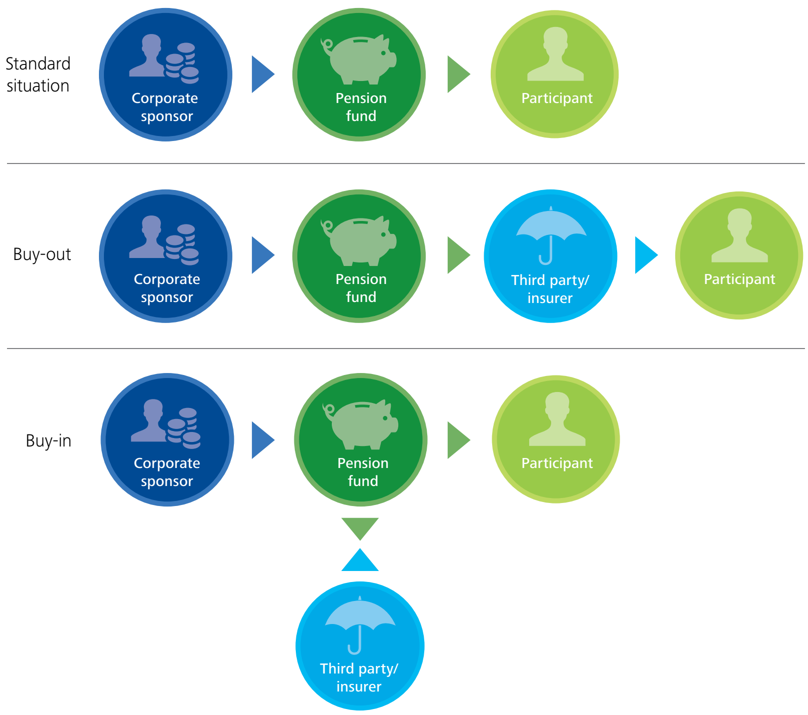
The last couple of years have seen an increase in pension funds and corporate pension schemes being transferred to insurance companies. These transfer deals, known as buy-outs or buy-ins, offer companies the opportunity to reduce their exposure to pension liabilities. Evolving accounting regulations, volatile equity markets and a transfer of risk from corporates to individual participants have increased the speed of this process.

Employee benefits have turned into a financial liability for corporates, with limited upside. Depending on their risk appetite, it can be very attractive for a pension fund or corporate to transfer some of the risks to third parties—especially for companies seeking to reduce balance sheet exposure and small pension funds with high individual longevity risks or high operating cost levels. In making such an important decision, it is advisable to use a roadmap and monitor the different risks, while at the same time, it is important to ensure an optimal outcome for stakeholders and lock the potential of future benefits.

Introduction to liability transfers

For most companies, pension schemes are no longer considered a key part of their human resource strategy in the pay/benefit package offered to employees. Final salary-based pension schemes are very scarce these days, as employers increasingly transfer pension risks to the employee. Instead of the final salary or defined benefit plan, where the employer offers a pension scheme at retirement and bears the associated risks, employers make a contribution to the individual's defined contribution plan. In a defined contribution plan, the participant bears the risks and the outcome is less certain, without the guarantees of the sponsor.

Figure 1: Overview of buy-in vs buy-out



Source: Deloitte

Furthermore, existing defined benefit employee schemes represent a risk to the corporate sponsor, and can place a significant burden on corporate profits. As a consequence, both corporates and pension funds are investigating the possibilities of outsourcing the risks involved with these contracts. Buy-outs are used to initiate the transfer of pension liabilities to insurance companies. In a full buy-out, this results in the liquidation of the corporate pension scheme, as all liabilities and the investment portfolio of the pension fund are transferred to a third party, an insurer for example.

After the buy-out, the insurer becomes responsible for the fulfilment of all pension promises and the former corporate pension sponsor no longer has any links with the pension scheme and its members. Instead, the pension scheme member (an employee, former employee or retiree) has a pension insurance contract with the insurer. The pension fund no longer has any reason to exist if the liability has been removed, except for the purposes of quality assurance with respect to the third party or insurer. Alternative options include a buy-in, where the pension fund insures a portion of the risk, in relation to longevity for example.

Opting for a buy-out is a major decision for a company board, a trustee board or a pension fund. Most central banks have specified requirements for approval of these liability transfers, due to the potential risks for the participants of the fund or scheme. Although, the liquidation process is often overlooked in the day-to-day funding process of a pension fund or corporate, it could be worth considering, since it can meet the needs of employees as pension promises are fulfilled. This option is likely to be re-examined, with interest rates set to increase and in light of the recent strong performance on the equity markets.

Market developments

The landscape for pension funds is changing rapidly as a result of increased pressure from the regulators on governance models. Pension funds are liquidating or consolidating due to environmental challenges. Only the largest pension funds are expected to have sufficient financial means and economies of scale to survive. For example, in the Dutch market, estimates show that a quarter of existing pension funds are in the process of, or are making preparations for, the transfer of their assets and liabilities to other pension funds or insurance companies, while the remaining Dutch funds are investigating the steps necessary for a buy-out in the short term. Similar trends can be observed in other European countries, such as the United Kingdom.

Collective transfers of liabilities are attractive for pension funds, corporates and other financial institutions aiming to decrease exposure to pension liabilities on their balance sheets. In the case of corporate pension schemes, the move to fair value accounting under IFRS introduced market risks to corporate balance sheets. Some large multinationals face large pension liabilities that are significant compared to their annual revenue, and those liabilities are also volatile. In December 2012, the Dutch postal service (PostNL) announced that it would make an extra payment of €84 million to the corporate pension fund[1].

Some companies have a significant value of a pension fund (assets and liabilities) on their balance sheet, sometimes this is multiple of the value of the company without the pension structure. It is questionable whether such companies are operational entities or pension funds in disguise.

Financial market conditions have added to the impact of the changes in accounting regulations, and have increased the trend towards the collective transfer of liabilities and assets, whereby pension assets and liabilities are outsourced to insurers, with the aim of reducing the volatility of pension fund liabilities for fund sponsors.

Consequently, the pension scheme participant sees a transfer of his pension payments from the pension fund or corporate to the insurance company. Additional assets can be used to buy indexation of the nominal liability structure as part of the transfer. Thereafter, the insurance company takes on responsibility for payments, indexation and execution of the asset investment portfolio.

1 Source: ANP

Risks

Within the current turbulent financial environment, pension funds and corporates face one of the most important decisions in their history, the transfer of their legacy pension liabilities and assets to an insurance company in a one-off deal. Making the deal at the right moment can make a huge difference to the final payments the pension fund or corporate is able to make.

Most pension funds have the long-term goal of offering fully indexed pensions for their participants. In long-term bull markets, achieving this for closed pension schemes is more straightforward. With limited downward risk, as a result of large financial buffers (e.g. as expressed in a coverage ratio well above 100%), there is the possibility that excess assets will flow back to the corporate sponsor. The downward risk means that pensions fall short of full indexation and the upwards potential remains unfulfilled from a participant's perspective. This might not result in an optimal solution for all stakeholders, e.g. the pension beneficiaries.

In the current market environment—with low interest rates and low (although increasing) coverage ratios—opportunities for a full transfer are likely to be limited. However, a buy-out can be used to transfer a portion of the different risks:

- **Investment/market risk**—the risk that investment performance is below target and the investment portfolio is not sufficient to meet the (fully) indexed pension promise during the participants' lifetime
- **Inflation risk**—the risk that the returns on the investment portfolio are not sufficient to make pension payments during the participants' lifetime due to high inflation
- **Longevity risk**—the risk that increasing life expectations mean that pension payments are required over a longer period than funding is available
- **Employee sponsoring risk**—the risk that the sponsoring company is no longer able to cover deficits in pension contributions
- **Duration risk**—the risk that the pension promise cannot be met at maturity due to floating interest rates
- **Operational risk**—the risk that the pension fund is not able to make pension payments as a result of flaws in the operational process involving issues relating to governance, investment management or operational execution
- **Credit risk**—the risk that the pension fund provider defaults

Alternatives

When risks are moved from the pension fund balance sheet, it is reasonable to make a distinction between existing pension rights (of retirees and former employees and past rights from current employees) and future pension rights. These various rights holders might face different interests with respect to asset-liability-driven investments. Securing pension payments at retirement is the main objective for pension fund participants, which will mean a high percentage of fixed income investments. For pension payments to be built up in the accumulation phase, the objective will be to generate returns. If a full buy-out—where all the existing risks are transferred—is not possible, a partial buy-out may be used to transfer some of the risks.

A number of risk reduction options are available, depending on the risk appetite of the pension fund or the participants. The most common way of reducing balance sheet exposure is the shift from defined benefit plans to a defined contributions model. In the case of a company insolvency, there is no secure future for its pension scheme, and a buy-out should be considered. A transfer of liabilities might be considered by:

- Companies seeking to reduce on-balance sheet liabilities
- Smaller pension funds exposed to large risks due to undiversified longevity risk
- Pension funds with high operating costs

Should a full buy-out not be possible, the options for transferring a portion of the risks are:

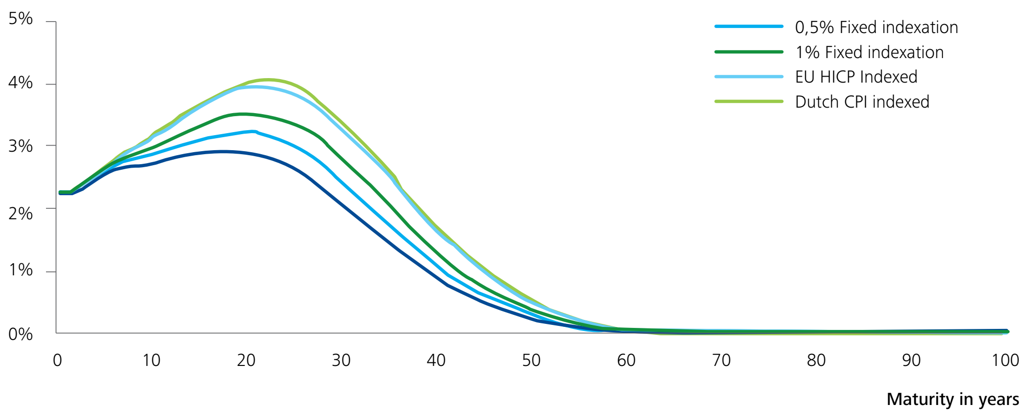
- A buy-in, with a third party or insurer becoming responsible for all or part of the pension promises. However, the corporate pension sponsor retains its relationship with the pension scheme members, and the corporate or pension fund transfers the risks to an insurance company
- A partial buy-in, based on the risk appetite towards different risks corporates might chose to execute a partial buy-in. For example, where only longevity risks or inflation risks are transferred
- A deferred buy-out, where the transfer of existing liabilities and assets is made in a number of tranches over the following years. With this option, the risk parameters can be fixed or adjusted in relation to market movements (respectively inflation or interest rate subject to market fluctuations)

In both the buy-out and the buy-in, the transfer of the pension liability to the insurer can be accompanied by a premium payment from the corporate pension fund sponsor. The premium is expected to cover the deficit between the current pension fund assets and the future liabilities. This premium is often used to buy fixed indexation or indexation based on a variable index, such as a consumer price index.

Pricing drivers

A collective transfer of a pension balance sheet for a company or a pension fund is essentially a discounted cash flow calculation of the liability structure, based on the scheme and the actuarial assumptions, such as mortality expectations. The overview of the cash flows at different indexation levels are presented in figure 2. The lowest possible price for these liabilities (as paid by the third party) will result in the highest possible indexation for beneficiaries. The market for collective buy-outs has expanded significantly, with new entrants and even non-traditional market players trying to get in on the act, thereby putting pressure on pricing methodologies. The increased competition has forced insurance companies to look at these deals from an investment management and financial engineering perspective. Whereas cash flows were previously discounted at zero rates derived from swap rates, nowadays spreads on discounted curves are commonly used, resulting in higher amounts of fixed indexation or indexation matched to inflation. The main pricing drivers are interest rates, spreads, longevity parameters, indexation targets, inflation commitments and the cash flow pattern of the liability structure.

Figure 2: Indexed Pension liability scheme with fixed and variable indexation



Assumptions: Dutch inflation based on a premium of 10 basis points above EU inflation and based on an average maturity for a pension fund scheme.

Source: Deloitte Analyses

These complex pricing deals, referred to as the mergers and acquisitions of the pension market, are depending on lots of different parameters impacting the pricing. For participants of a pension scheme matching inflation has always been a major item in the realisation of continuous purchasing power. These detailed pricing parameters, like expected inflation, inflation capping or providing floors on inflation to compensate deflations have a significant impact on the pricing.

Conclusion

Pension liabilities represent a substantial risk for corporates, and the removal of these risks from the balance sheet needs to be managed carefully. This can be accomplished either through buy-outs or (partial) buy-ins. Market competition among third parties has increased the opportunities to outsource all or some of the risks, and led such entities to price these deals more precisely and competitively. Effective risk reporting in these one-off deals is key to retaining control over the process. It could be worthwhile to continue the pension scheme, and outsource some of the risks, depending on the fund's risk appetite. In this way, the upward remains, but certain risks are limited so a more efficient outcome can be reached for all stakeholders. This is a continuous assessment for pension funds and their third-party counterparties involved in these deals.

To the **point**:

- Most pension funds and corporates are considering options to reduce the volatility of the pension liabilities on their balance sheets
- Liability transfers such as buy-ins and buy-outs can be an efficient way of removing this volatility
- As coverage ratios increase, liability transfers will become more viable