

# CALCULATED RISK

Pension buyout arrangements: are plan sponsors and members buying in?

BY ROB VANDERSANDEN AND WILLIAM DA SILVA

**T**he credit crisis has served to underscore plan sponsor risks associated with defined benefit (DB) pension plans. Does the solution to effectively managing those risks lie in passing on the responsibility for the plan's financial obligations to a third party, i.e., an insurance company?

This course of action—pension buyout, when the buyer takes over a plan's assets and liabilities for a premium and pays pensions to the plan members—was a growing trend in the U.K. prior to last fall. In a full buyout, a pension plan transfers its assets and liabilities to an insurer, which means that the trustees and the plan sponsor are no longer responsible for providing benefits to members. Partial buyouts, in which a plan transfers only a portion of its liabilities, are also possible. There is even a more extreme buyout model, in which an entire company is bought so that the acquirer can take responsibility for the company's pension plan.

A review of the conditions that led to the U.K.'s interest in pension buyout, and the more recent slowdown in the buyout market, may indicate whether this "ultimate risk reduction strategy" will take hold in Canada.

## **Pension Buyouts in the U.K.**

For many U.K. companies, buyouts became a viable option for managing their pension risks, as increasing competition in the buyout market allowed some plans to buy annuities at prices lower than the reserves they were holding in their financial statements. In other cases, trustees opted for a

"buy-in" strategy, investing in an annuity to cover a portion of the liabilities (typically, for pensions in payment) with the aim of better matching assets and liabilities. The costs involved are less than those for a buyout; however, the plan and its trustees remain responsible for paying the benefits.

A number of factors contributed to the growth in buyout solutions to manage pension risk in the U.K.

**Low interest rates** – In the U.K. (as well as in Canada and elsewhere), low interest rates have driven up pension plan liabilities, increasing the gap between a plan's assets and its liabilities.

**Longer life expectancy** – This factor is receiving increased attention as a risk element to take into account in determining defined benefit (DB) obligations. Previous actuarial assumptions in the U.K. needed to be updated. Using data from 2003 to 2005, the U.K.'s national statistics reported in 2006 that the average 65-year-old U.K. male is expected to live 3.7 years longer than he would have 13 years earlier, to age 81. Statistics Canada reports that, over the same time period, the life expectancy for a 65-year-old Canadian male increased by 1.9 years, to age 82.9.

**Increased compliance costs** – The Pension Protection Fund (PPF) and the pensions regulator were introduced in the 2004 *Pensions Act* with the goal of reducing risk in the U.K.'s DB pension system. The PPF charges risk-based levies while the regulator, whose role is to protect the interests of all DB plan members and limit the number of plans that call on the PPF,

# THE PRACTICE OF BUYING ANNUITIES TO DISCHARGE PENSION LIABILITIES HAS BEEN AN OPTION IN CANADA FOR DECADES. HOWEVER, IT IS NOW GAINING POPULARITY AS THE SAME FACTORS THAT DROVE THE U.K. MARKET BECOME MORE PROMINENT IN CANADA.

has the authority to intervene to protect members' benefits and impose penalties.

**Tougher funding standards** – The *Pensions Act* imposed new and generally tougher plan-specific funding rules for DB plans. The regulator now expects pension funds to target 70% to 80% of buyout costs for deficits to be made good in less than 10 years.

**Mark-to-market accounting standards** – Companies are subject to new accounting rules under the U.K.'s FRS17. These rules not only mark to market pension liabilities, exposing their inherently volatile nature, but they also put the liability figure on the company's balance sheet. The analyst community, in turn, is imposing greater scrutiny of the nature of liabilities and cash flow requirements. These factors are

leading pension funds to focus much more on reducing and controlling short-term risks relating to equity, interest rate (duration), currency and inflation.

The credit crisis has certainly put a damper on the attractiveness of acquiring companies for their pension plans. It has also slowed the movement toward pension buyout, as most plan sponsors can't afford to pay the premium required by insurers. However, insurers' pricing models have also been affected by the credit crunch and by increased competition. Those U.K. organizations that are still actively pursuing pension buyouts tend to have plans that are relatively well funded and also invest in assets that broadly match the plan's liabilities.

## The Member's Perspective

Plan members initially regarded buyout arrangements with some suspicion, concerned that they would put their future retirement income at risk. While no arrangement guarantees absolute safety, a buyout offers more security for many U.K. members than relying on the company sponsoring the plan.

For instance, insurance companies have to fund their pension commitments (i.e., annuities) very differently from the way a plan sponsor would. They must maintain a surplus at all times through contingency reserves. In contrast, many company-sponsored pension plans have substantial deficits that are only gradually being addressed.

What if the insurer goes bankrupt? These odds should be considered relative to the chance that the *plan sponsor* will go bankrupt. In the U.K., insurers are subject to an annual valuation (reviewed by the Financial Services Authority) and to the Financial Services Compensation Scheme, which is generally more comprehensive than the PPF. A similar regulatory structure exists in Canada, so the same considerations will apply when contemplating transferring pension obligations to an insurance company.

## A Canadian Opportunity?

The practice of buying annuities to discharge pension liabilities has been an option in Canada for decades. However, it is now gaining popularity as the same factors that drove the U.K. market become more prominent in Canada. For some organizations, this will essentially mean coming full circle: many plans started out as group annuity contracts that were brought in-house in the 1970s due to dissatisfaction with insurers.

Some DB plan sponsors will undoubtedly find it an attractive option. However, one challenge may be affordability. Pension

plans in North America have generally experienced the same investment losses as those in the U.K., so many can't afford to buy annuities now—despite the fact that annuity rates are favourable.

If a plan is only 70% funded and it buys an annuity for pensioners, then the funded ratio for the remaining plan members will drop below 70% after the premium is paid. Pension regulators generally won't allow this type of transaction unless the sponsor commits to contributing enough to boost the plan's funded ratio back up to 70%—which, in the current economy, plan sponsors will be loath to do. This may make buy-in strategies more common in the short term until plans' funded positions improve.

Hewitt Associates' *Global Pension Risk* survey, conducted last year, found that Canadian plan sponsors are generally behind their global counterparts when it comes to managing pension risk. This is perhaps surprising, as Canada stood out as the region where DB plan closures to new employees were less prevalent—which leaves Canadian employers more at risk to the changing financial and regulatory environment than many of their non-Canadian counterparts.

As more Canadian plan sponsors start to actively measure those risks—and as Canada moves to international accounting standards in 2011—options such as buyout arrangements to manage or transfer risk will receive more attention.

In Canada, as in the U.K., the size of the group annuity market is relatively small compared to the size of private sector pension plans. New players are likely to emerge, including traditional insurance companies and other financial institutions. Some Canadian insurers are already active in the U.K. and are positioning themselves to take advantage of the Canadian buyout market once the financial positions of pension plans start to improve.

Plan sponsors interested in taking advantage of buyout opportunities can start planning now by cleaning their data, reviewing their investment strategies and considering any issues with their benefits structure. When conditions improve, these organizations will be better positioned to quickly take advantage of such opportunities as they arise. **BC**

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