

# Pensions buyout and settlement market

## The corporate perspective

Settling pension scheme liabilities is a hot topic for corporate scheme sponsors. The rapidly developing settlement market now consists of a wide range of providers – from insurers, to banks, to niche providers, with a diverse range of solutions extending far beyond the traditional buyout.

Watson Wyatt's corporate consulting group seminar on the settlement market (26 March 2008) was attended by nearly 100 senior representatives of companies with defined benefit (DB) pension schemes.

This factsheet summarises survey voting results gathered during the seminar, and compares them with the corresponding results from the previous seminar a year ago. Key points to note are:

- Pensions are firmly on the corporate agenda as a significant issue for over 90 per cent, with almost three quarters discussing settlement at board level.
- Settlement costs are reducing due to allowance for credit spreads in providers' pricing and competition between providers. Lower prices are potentially bringing settlement within reach for more corporates.

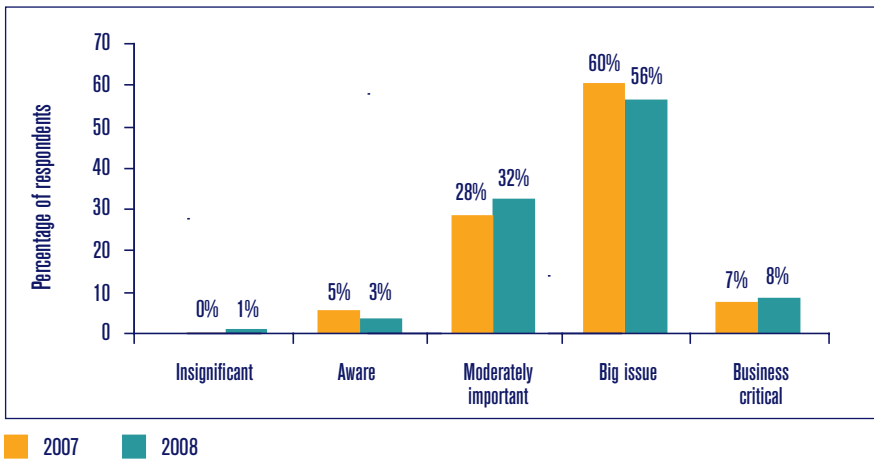
- After price, security is the next key concern on settlement for corporates.
- More competition, and especially lower prices, mean that the time horizon over which corporates think they may be able to settle liabilities is shortening.
- It is an open question whether current pricing levels are sustainable in practice or are simply a short-term phenomenon driven by temporary market conditions and competitive pressure.

### How high is the settlement issue on the board agenda?

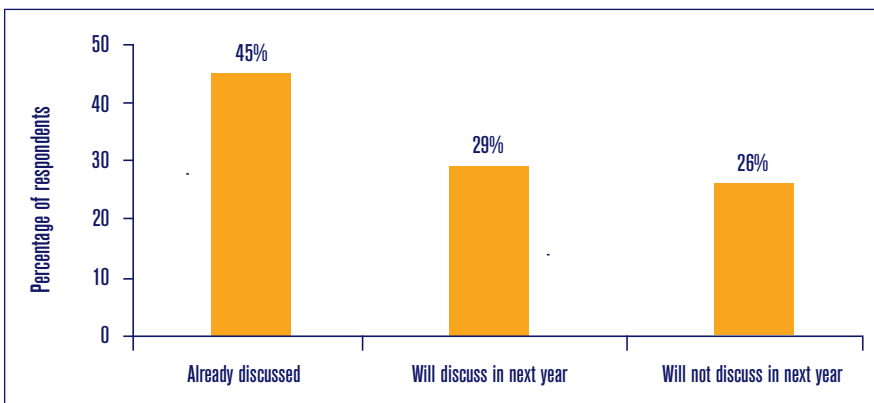
As in 2007, most delegates indicated that pension issues were of at least moderate significance to their board, and for a clear majority they were either a major or critical business issue (see Figure 1, overleaf).



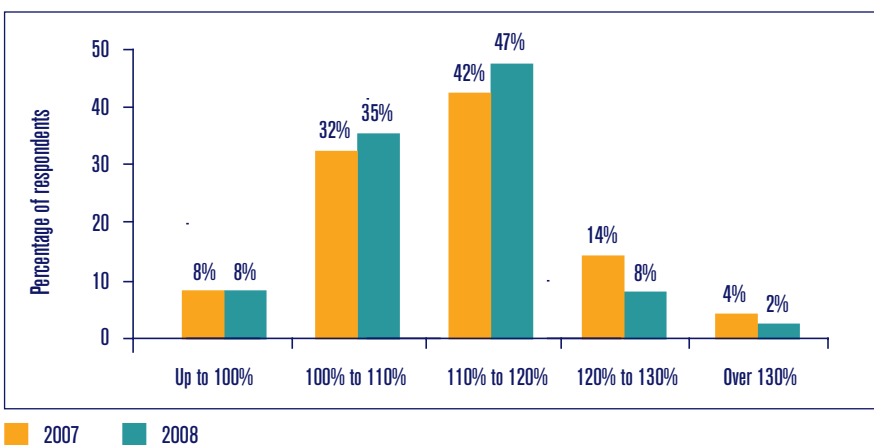
**Figure 1 | Importance of buyout for company board**



**Figure 2 | Settlement discussions in board meetings**



**Figure 3 | How much would you pay relative to accounting (IAS 19) liabilities to buy out?**



This year we also asked whether a specific discussion on settlement had taken place in a board meeting or if it would within the next year. Almost three quarters said that the issue is receiving this level of attention, with 45 per cent already having discussed it at a board meeting (see Figure 2).

### How much are sponsors willing to pay to settle pension liabilities?

The pension accounting liability under IAS 19 or FRS 17 is a key benchmark for plan sponsors. Since 2007, increasing yields on corporate bonds (the key driver of accounting liabilities) have led to a better accounting position. However, this ‘improvement’ has been offset to some extent by many sponsors incorporating the assumption that scheme members will live longer than previously expected; thus increasing liabilities. Against this backdrop, we again asked sponsors how much they would be willing to pay to settle their pension liabilities compared to the accounting benchmark (see Figure 3).

As in 2007, the most likely range of ‘willingness to pay’ is the 110 per cent to 120 per cent of IAS 19 level, albeit now relative to a somewhat weaker IAS 19 base.

Whilst this might suggest that the willingness to pay a premium has, if anything, declined a little in ‘cash’ terms, it seems more likely that it actually reflects corporate sponsors’ growing awareness of the increasingly competitive market pricing. There is evidence that a few deals have indeed been done at below 120 per cent of IAS 19.

There appear to be two key drivers of this lower pricing level – stiff competition between providers and a willingness by some providers

to allow for increased corporate bond yields in their pricing models. Whether this level of pricing is sustainable in the longer term is very much an open question. Sponsors therefore need to consider whether there is potentially a current market opportunity for settlement in one form or another.

### What factors, other than price, drive the settlement decision?

This was a new question this year and elicited a very clear response. Security is, with the exception of price, the clear 'number 2' factor for corporates. Whether this simply means security for scheme members' benefits, or a greater focus on avoiding residual risk 'bouncing back' onto the sponsor later, is something we will have to explore further!

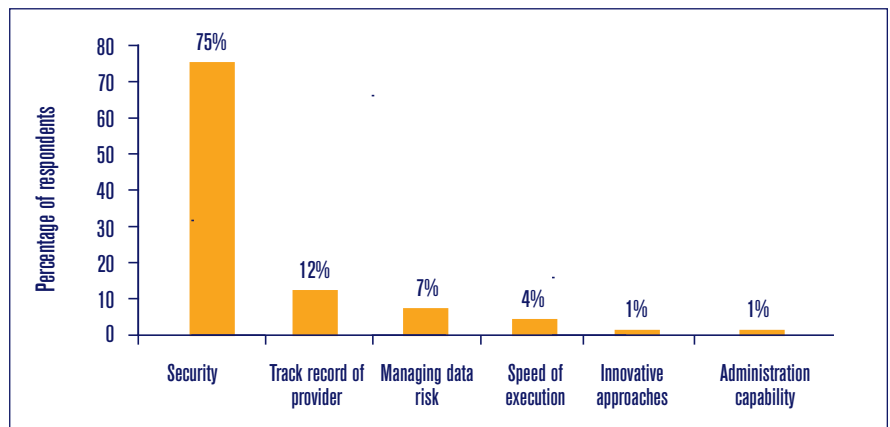
As Figure 4 shows, other features some providers have sought to use to differentiate their offering in the market scored substantially lower with our delegates, particularly as provider track record, the next most popular item, also has a flavour of security about it.

### How quickly, and in which ways, will the settlement market develop?

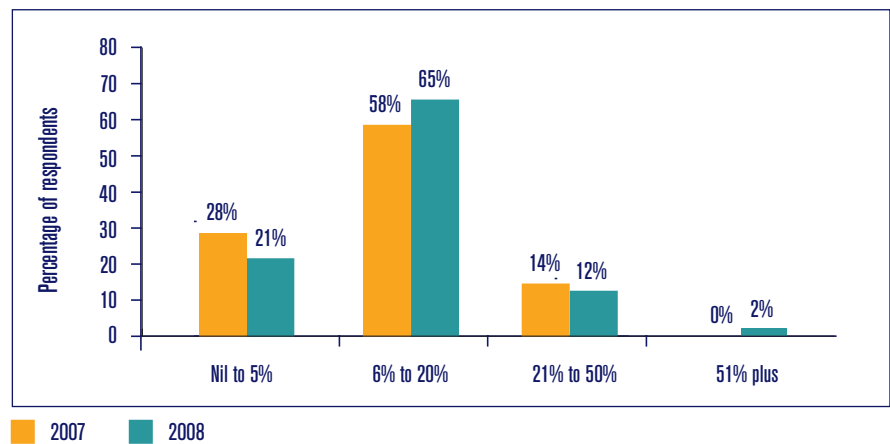
The likely speed of growth and diversity of the settlement market is the area where delegates' views were most different from 2007.

Against a back drop of around 0.5 per cent of total scheme liabilities being settled in 2007, delegates are now expecting perhaps 20 or 30 times that amount to be settled over the next three years, which would be a huge increase (see Figure 5).

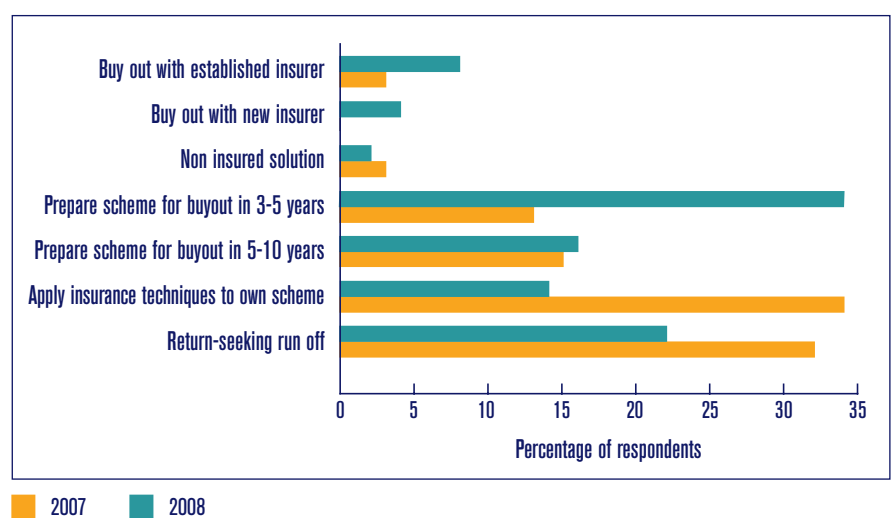
**Figure 4 | Other than price, what is the key consideration?**



**Figure 5 | Percentage of total DB liabilities to be settled in the next three years**



**Figure 6 | Approach to settling liabilities**



The delegates' perspectives on the way in which liabilities will be settled has also evolved – probably reflecting the perception that buyout is now more affordable (or closer to becoming affordable) than previously thought, for the reasons highlighted above.

Do-it-yourself settlement solutions (run-off and/or applying insurance style techniques in your own scheme) are, conversely, currently seen as less popular – with 36 per cent expecting to follow this approach, compared to 66 per cent last year (see Figure 6). This could represent a view that such solutions are most practical for larger schemes (which would mean considerably more than 36 per cent of the total by asset value) or simply be the flip side of the current perception that buyout is more affordable.

## Conclusions

Taken together, these results suggest three key points:

- pension settlement remains high on corporate agendas
- competition, growing familiarity and, particularly, more attractive pricing may be bringing settlement within reach of more companies
- significant further development and growth in the settlement market seems likely.

## Watson Wyatt's corporate consulting group

Watson Wyatt's corporate consulting group helps companies optimise the risk and reward management of their pension and employee benefit arrangements.

Companies are faced with increasing costs and risks and decreasing control over their obligations. The issues, that for many corporates need to be addressed, lie on a spectrum between managing the legacy (dealing with past obligations efficiently and effectively, either via buyout, internal settlement or long-term run-off) and strategy for future business (implementing solutions to drive the business forward).

We offer practical, business focused advice to clients across a spectrum of issues.

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