

# corporate briefing



## Settling pension liabilities What every CFO should know

### Summary

There is a vast range of pension settlement options now on the market – and they are proving an attractive and real proposition for an increasing number of companies. They may not be a complete panacea, but they do provide a flexible and valuable toolkit which allows CFOs to optimise their company's pension risk position.

Open the business section of any newspaper and you will find a story about pension buy-outs, pensioners being 'abandoned' by their employers, or even so called 'zombie funds' picking over the remains of company pension schemes.

When you get behind the journalistic hyperbole, there really is a significant change happening that every CFO responsible for a defined benefit pension scheme should know about.

### What's the issue?

For many companies, pension liabilities are large relative to the size of the business. They are also volatile and hard to manage because they are impacted by economic factors such as investment markets and inflation, legislation and regulatory changes, and increasing life expectancy ('longevity risk'). This has resulted in a range of settlement solutions being developed to 'take the problem away'.

### What are the settlement options?

There are many options along a spectrum from the fully insured buy-out to the 'do it yourself' internal settlement. The main categories are:

- **Fully insured buy-outs:** This involves securing all the liabilities with an authorised insurer and should provide a clean break in exchange for a one off cost. This can be a very big number but, depending on your particular scheme, could be lower than the indicative buy-out cost in the actuarial valuation.

Key players in this market include Legal & General and Paternoster. Lucida have recently struck their first deal and there are many others ready to do so, such as the new insurer Synesis and overseas entrants to the UK market such as AIG and MetLife. These will add to the other established insurers such as Aegon, Norwich Union and Prudential.

- **Partial, staged and risk-sharing buy-outs:** Partial buy-out is, for example, for current pensioners but not those whose pension is not yet in payment. This is essentially about either managing cash (if full buy-out is too expensive) or finding a particularly competitive segment of the buy-out market. In some cases, e.g. P&O, this may be a 'buy-in' where the insurance is held as an asset of the pension scheme.

Some providers offer variations on full and partial buy-outs which involve staged transfers and/or the possibility of some risk sharing between company and insurer.





## Settlement options provide a flexible and valuable toolkit...



- **Pension regime solutions:** To avoid the more onerous reserving requirements in the insurance regulatory regime, or simply to speed up the settlement process, several settlement solutions which stay in the pensions regime have been developed.

In the CitiGroup/Thompson Regional Newspapers case, essentially Citi took over from TRN as the pension scheme sponsor, and thus provider of the sponsor covenant, presumably aiming to run off the scheme at lower cost than a buy-out. The Pensions Corporation cases (Thorn/Thresher and Telent) are essentially similar to this, but the sponsoring company was purchased and then sold on, leaving the scheme to be run off by the Pensions Corporation.

There are also solutions which remain in the pension regime short-term whilst steps are taken to reduce liabilities before moving to a fully insured buy-out for the remaining liabilities, e.g. the approach offered by Goldman Sachs (as chosen recently by Rank). Other variants involve a longer stay in the pension regime, perhaps 10 years, during which time the provider guarantees investment performance which helps increase funding to buy-out level.

- **Capital market solutions:** New providers such as Pensions First are developing capital market offerings which would provide AAA backing for the pension liabilities, though the scheme remains with the existing sponsor. In principle, these are a 'bundled product' version of the internal settlement approach described below.
- **Alternative insurance solutions:** There is also a range of new forms of insurance, covering the scheme against some or all of longevity risk, economic risk, and sponsor insolvency risk.

Brighton Rock, for example, insures sponsor solvency and, on failure of the sponsor, transfers the liabilities to its life insurance subsidiary which meets the liabilities with the scheme assets, any funds recovered from the failed sponsor and additional payments from Brighton Rock as necessary.

- **Internal settlement:** Liability driven investment ('LDI') has been widely adopted as a key plank in internal settlement approaches. Essentially, LDI takes a projection of the expected cash flows out of the pension scheme and seeks matching investments to deliver the corresponding income stream to the scheme. Interest rate and inflation swaps, and other products, are widely available to support this sort of approach.

However, the projected cash flows used for LDI depend on a number of assumptions, in particular regarding mortality, which means longevity risk remains. New products from providers such as Credit Suisse, JP Morgan and Natixis are emerging to 'swap' away the mortality risk, based on standardised or scheme-specific mortality.

- **Settlement with scheme members:** In conjunction with any of the above, steps can be taken to settle liabilities with scheme members themselves. Enhanced transfer value exercises are the best known. They offer members a higher transfer than they would normally get but still less than the buy-out cost. The normal transfer is made to a personal pension while the enhancement may either be paid to the personal pension or as cash to the individual. Provided the deal is explained clearly to avoid future claims of mis-selling this is a potential win-win situation.



Other variants include encouraging early retirements, maximising cash lump sums members take on retirement, cashing out trivial benefits, and trading non-statutory pension increases, all of which can reduce cost provided mis-selling is avoided.

## Conclusion

There is now a plethora of pension settlement options on the market. They do not offer a panacea for companies' DB pension issues any more than they are the evil sometimes portrayed in the press. They do, however, provide a flexible and valuable toolkit which allows CFOs to optimise their company's pension risk position.

At Watson Wyatt we have worked with companies on all of these options. If you would like further information please contact your Watson Wyatt consultant or:

**Steven Dicker**

+44 (0) 7808 176397

[steven.dicker@watsonwyatt.com](mailto:steven.dicker@watsonwyatt.com)

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**Rashpal Bhabra**

+44 (0) 121 644 7362

[rashpal.bhabra@watsonwyatt.com](mailto:rashpal.bhabra@watsonwyatt.com)

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March 2008

Ref: 2008-COR-MKT03