

# hot topics



## Another giant leap for the bulk annuity market

### Key issues

The Cable & Wireless Superannuation Fund's £1bn bulk annuity transaction is understood to be the largest such transaction between a pension scheme and an insurer.

This is a buy-in: the bulk annuity policy is written in the name of the trustees and will be held alongside the Fund's other investments.

The contract has certain additional security features – we believe that trustees and plan sponsors of other funds not already familiar with the importance of additional security will look at this transaction and seek to understand why it is important and what they may be able to achieve for themselves.

This may therefore prove to be a landmark transaction for reasons other than size alone!

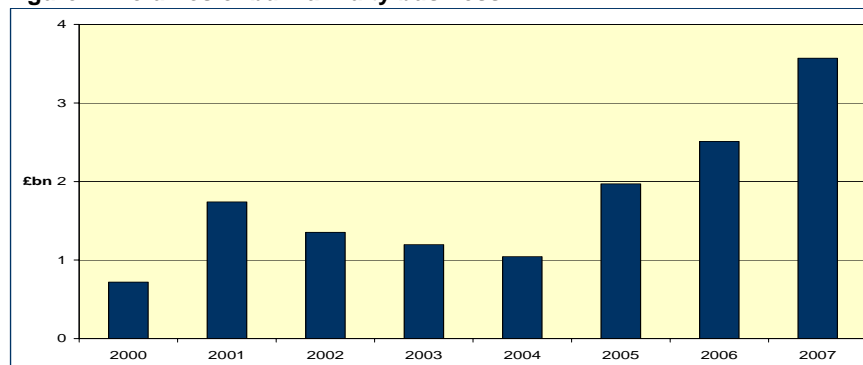
Earlier this week, the Cable & Wireless Superannuation Fund secured its pensioner liabilities with Prudential, in a deal that breaks new ground in what continues to be a rapidly developing market. Watson Wyatt was the lead adviser in this first £1 billion bulk annuity transaction between a pension scheme and an insurer. An unusual feature of the contract is some valuable security that the trustees successfully negotiated that gives members added protection in certain future scenarios. In this bulletin, we discuss the developing market in pension settlement and explain the purpose and benefits of building additional security into buy-in contracts.

### How the market has developed

In the recent past, Legal & General and Prudential dominated the bulk annuity market, with few other insurers showing much of an interest in this type of business. For most company pension schemes, it was too expensive to settle their defined benefit (DB) pension liabilities by buying annuities; those that did so were typically in the process of being wound up, often as a result of employer insolvency.

This has changed beyond recognition over the last two years. A number of new players have entered the market, prices have become more competitive, and volumes of business written have grown rapidly - from less than £2 billion a year pre-2005 to £3.6 billion in 2007, with market predictions that £10 billion of business will be written in 2008.

Figure 1: Volumes of bulk annuity business



Before 2007, large bulk annuity transactions were uncommon, with two standing out: C&A (c.£400m) and Dalgety (c.£500m), both with Prudential. This started changing in 2007, which saw at least nine transactions of over £100m, including two of over £500m, the largest of which was between P&O and Paternoster. 2007 also witnessed Pension Corporation acquiring Telent and Thorn, which had pension funds of around £3 billion and £1.2 billion respectively, because of its interest in those companies' pension schemes. These were non-insured solutions representing a business model that appears less attractive now, following the well reported intervention last year by the Pensions Regulator in relation to Telent.





Whilst Prudential did not feature strongly in 2007, with L&G and Paternoster grabbing the lion's share of new business, the Cable & Wireless Fund's transaction marks its return to the limelight as a major player in the bulk annuity market. This deal on its own exceeds 25 per cent of aggregate business transacted by all insurers in 2007.

As well as being the lead adviser in relation to the Cable & Wireless Fund's transaction with Prudential, Watson Wyatt advised either the trustees or the company in relation to all of the transactions mentioned above.

### **Increasing sophistication**

As is often the case in a rapidly developing market, the products available are evolving and becoming more sophisticated to better meet the needs of customers. As a general rule, most of the innovation is taking place on larger transactions, as insurers are generally willing to offer bespoke solutions, taking on board new ideas put to them by their potential customers and their advisers.

In our view, the Cable & Wireless Fund's bulk annuity contract with Prudential is an excellent example of innovation that pushes boundaries and helps shape the nature of products available in the market. One important but unusual feature is that the trustees have successfully negotiated additional security providing added protection for the scheme sponsors and trustees (and therefore also members).

### **Additional security: why?**

A common feature of the bulk of the larger pensioner-only transactions that have been announced over the last eighteen months is that they have been buy-ins. In other words, the contract with the insurer has been an investment of the scheme. The plan's trustees do not discharge their liability to pay pensions – if the insurer were to run into financial difficulties, the plan would ultimately still be required to pay those pensions.

Without appropriate security arrangements, the trustees (and therefore the employer) would have a concentrated and potentially substantial exposure to the future welfare of the insurer.

If the insurer were to fail, and the trustees were not able to recover from it the full amount required to pay pensions, they may have some recourse to the Financial Services Compensation Scheme (FSCS). The FSCS is itself not bullet-proof as it remains untested to the failure of a large insurer, and in any case will not pay out benefits in full, typically covering only around 90 per cent of benefits promised on a large bulk annuity contract.

The shortfall would then have to be met by the plan sponsor. Without question, this would not be welcomed by the sponsor, who would already have paid for the liabilities once and would not wish to pay for them again. Indeed, the set of economic circumstances that had caused the insurance company to fail may well have also taken their toll on the plan sponsor, so any call for further funding on the sponsor may come at a time when it can least afford it.

### **Different forms of security**

There are different mechanisms by which funds can achieve added protection. In broad terms, there are two alternative structures:

- Not to hand over all of the premium to the insurer until the trustees have discharged their liability in full.



- Collateralisation - essentially, earmark an identifiable pool of assets that would be available to the trustees if the insurer were to run into financial difficulties, which they could then use to pay pensions or secure them with another insurer.

Clearly, the level and structure of collateralisation is important as this dictates the amount the trustees could expect back if the insurer hits troubled waters. It should be noted that, at least for now, collateralisation is not always going to be possible, particularly for smaller transactions.

### Where next for the bulk annuity market?

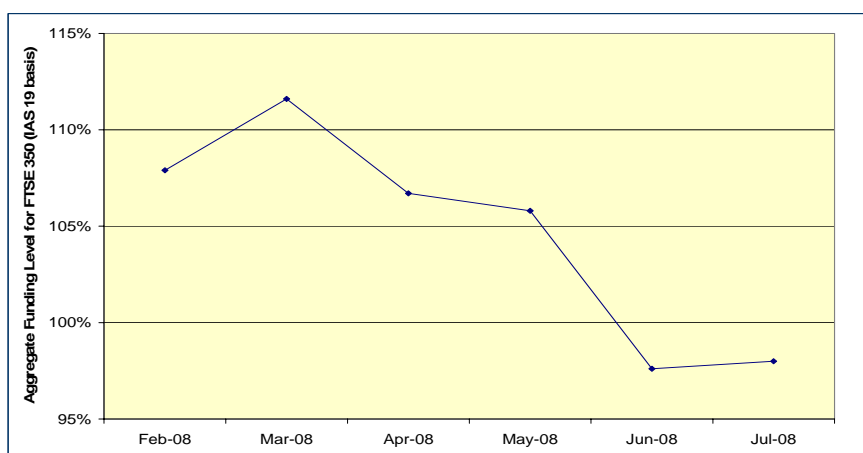
The Cable & Wireless Fund's deal with Prudential raises two interesting questions about the future of the bulk annuity market.

The first is to what extent, and at what cost, additional security will feature in future bulk annuity transactions. A few insurers have resisted building in the level of security that is desirable to pension funds. Trustees and sponsors will increasingly seek protection from a decline in the future of the insurer's well-being as they become aware that this is possible. Those insurers who are not keen on providing additional security may have to rethink their position if they wish to remain competitive. We know from our discussions with some that this is already happening.

The second concerns the likelihood of the insurance market continuing to grow at the rate it has done over the last 18 months. Three factors could lead to a slowdown, at least in the short term. These are:

- The funding position of most pension schemes has deteriorated in the last few months because of a fall in equity investments combined with increases in liabilities as a consequence of rising inflation. This will push up the cash call upon plan sponsors in order to finance future transactions, making them less attractive.

**Figure 2: Aggregate Funding Level for FTSE 350 (IAS19 basis)**



- Some insurers have indicated that if they are involved in a big deal, they may slow down their pursuit of further business for a period of time while they bed it down, which may temporarily reduce market capacity.
- There has been a reduction in liquidity of the inflation swap market, as a consequence of the credit crunch. Insurers will typically wish to invest to match as closely as possible any liabilities they take on, and this usually involves substantial investment in inflation swaps. Lack of liquidity in this market could therefore have knock on implications for the growth of the bulk annuity market, or at least it may increase bulk annuity prices which in turn may result in a slowdown.

## Further information

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Even if there is a slowdown in the growth of this market, we expect this to be temporary. Based on the work we are doing with our clients, there is a healthy pipeline of business that should keep insurers busy for quite some time yet, and we expect that they in turn will be innovative in finding ways of overcoming growth constraints. For example, they may achieve this by reducing capital constraints via reinsurance or mortality risk trading, or through 'syndication' (which some insurers are in favour of, although we believe care needs to be taken to maintain competitiveness).

## How can Watson Wyatt help?

Once a complex bulk annuity contract has been signed, there is no turning back. Getting it wrong can be very costly, and so schemes need advisers who can negotiate the best possible terms (including price and other contract terms, such as collateralisation or other security features) and are able to deal with every aspect of the transaction (for example, transitioning from the current investment strategy to one acceptable to the insurer, in a short space of time, often using derivatives).

Schemes therefore need advisers who have a proven track record and deep experience in defined benefit actuarial and investment consulting, as well as the know-how to work with and influence insurance companies. Watson Wyatt offers a unique combination of these attributes:

- Our market leading position as actuaries to DB schemes has been established over many years – we are actuaries to almost half of the 100 largest UK corporate pension funds, giving us the most wide ranging and diverse experience.
- We have a reputation for developing leading-edge investment service offerings in a wide spectrum of specialist fields – we are advisers to pension schemes with total assets amounting to just over one-third of the aggregate assets of UK corporate pension funds.
- We have a deep understanding of the insurance market - when negotiating with insurers on behalf of our clients we involve experts from our specialist Insurance & Financial Services practice, who have worked for, or advised, insurance companies and who understand the providers, their terms and conditions and their balance sheets.
- Project managing the entire end to end process - this involves engaging, managing, co-ordinating and communicating with many participants, such as actuaries, lawyers, investment consultants, covenant providers and insurance companies, to ensure the process stays on track to deliver on key milestones and goals.

In partnering with our clients we initially focus on helping them develop an overall strategy for derisking their pension scheme. We then draw on our expertise in each of the relevant areas to create and deliver the structure and outcome which will best meet their needs.