Expert view: Rothesay Life

The Return of Full Buy-Outs... and Data Risk

With the collapse in solvency levels following the credit crisis, full buy-outs have been out of reach for many pension funds that would otherwise seek to de-risk. The focus has instead been on bulk annuities that insure some or all the liabilities for current pensioners – a so-called "buy-in". One result of this focus has been that pensioner buy-ins have become simpler and quicker to execute than a few years ago; the process for executing transactions has become finely tuned through familiarity and routine. With the recent recovery in markets and pension fund solvency levels, the focus for corporates is now shifting to the desired endgame of full buy-outs. So, with this shift there seems merit in considering how, in practice, a buy-out differs from a buy-in?

ACCURACY OF DATA IS IMPORTANT

Whilst most full buy-outs start as buy-ins (with a clear intention that individual policies will be issued), there are some key differences in the way they are structured at the outset. One of the key differences lies in the management of member and benefit data. Because a buy-in is held as an investment of the pension fund, there is no immediate need for the insurance to match the individual members' benefits precisely. However, when a pension fund is fully bought-out, the liability to provide pensions to its members is transferred in full to the insurer. It therefore becomes vital that the correct benefits are insured for every single member and this requires significant extra work, ensuring the liability data is correct.

Whilst many pension funds have been working over recent years to cleanse their data, there will always be potential for errors to remain uncorrected and for eligible members to be missing from the data set; frankly because these are difficult issues to correct and are easily put on the "back burner". GMPs, if not reconciled yet will also lead to benefit changes and there is, of course, the thorny topic of GMP equalisation; two time-consuming and costly issues to fix. All of these issues lead to uncertainty in the pension fund's liabilities and, when those liabilities are being handed in full to an insurer, the question arises as to who will cover the cost of any corrections that might be required after the bulk annuity has been secured.

In the context of a full buy-out, some trustees will continue to rely on a legal argument to avoid any requirement to make corrections after completion of the wind-up. However, the process of wind-up and converting the bulk annuity into individual policies can take years, leaving residual liabilities with the trustees and corporate for all that time. In addition, trustees of larger funds (at least) aspire to ensure that errors in benefits are corrected irrespective of when they emerge.

THE NEED FOR COST CERTAINTY

Uncertainty in liabilities can create difficulty in securing appropriate insurance; three different examples come to mind:

1. It is usually the case that the corporate sponsor must make a contribution for the full cost of a buy-out to be afforded. It is understandable that the corporate and its board would like certainty of this amount and not have to wait potentially years to know what the final cost is.

2. Trustees who are lucky enough to have a surplus in their pension fund will want to spend at least part of it on benefit augmentations; they will therefore want to be sure that they

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have fully secured the current liabilities before spending any of that surplus on increasing the liabilities further.

3. Similarly, trustees that are trying to escape their pension fund tipping into the PPF by insuring liabilities instead, will want to know with absolute certainty, that they have insured benefits at least equal to PPF compensation.

Increasingly over the past five or six years, driven by a need for certainty, pension fund trustees and corporates have sought to insure the risks associated with data errors and other risks such as GMP equalisation methodology (referred to collectively as "Data Risk").

UNDERWRITING DATA RISK

For an insurance company to underwrite Data Risk, pre-transaction due diligence is key. This is carried out through detailed analysis of the pension fund's governing documentation, the data held on its administration systems and the administration practices adopted in paying benefits historically. Further, the insurer will review how pension legislation has been applied in order to determine whether there might be any issues that could materialise in the future. The most common cause of problems is failure to effect gender equalisation in a legally-robust fashion following the 1990 Barber Judgment.

Following the due diligence process, the insurance company will assess the cost of providing cover against Data Risk. The two components of this premium will firstly be the cost of making corrections that would normally be picked up by a post-transaction, pre-assignment data cleanse and secondly a premium for the issues that may emerge in the future but cannot be corrected in a data cleanse. If insurance is bought for both of these components then the trustees and corporate can achieve certainty on the liability costs. This approach mitigates problems that would arise if an unexpected cost emerges as an unwelcome surprise after the trustees have put the bulk annuity in place. Having this certainty makes it much easier to move forward in executing the bulk annuity and then in completing a buy-out.

TOP TIPS FOR COMPANIES STARTING TO LOOK AT BUY-OUT

- Work with advisors (actuarial and legal) that have a wide experience of full buy-outs
- Understand the sponsoring employer's likely budget for shortfall and tolerance for overruns
- Estimate the corporate accounting impact and decide preferred timing of completion of settlement
- Once the sponsoring employer's parameters are defined - set up a joint working group of company and trustee representatives to oversee the process
- Research the area of uncertainty in the liabilities (Barber windows are the most common issue) and review options on how to resolve

For corporates wanting a quick and full settlement of liabilities, this additional insurance has an interesting by-product. The management time and costs taken to completely wind up a trust can be disproportionate even after a full buy-in has been put in place. Purchasing cover for Data Risk can enable a much quicker and simpler move to assignment; removing the liabilities from the corporate pension accounting balance sheet at an earlier stage. ■

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