Issues when outsourcing pensioners

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Agenda

- Key issues to consider
- The difficult parts

Issues – type of pension

- The type of pension secured is the most important decision and also the most difficult one
  - Level (or guaranteed escalation) pension: generally avoid as it exposes the member to inflation risk (need to be sure that inflation will not increase significantly)
  - Inflation linked pension: the most suitable pension for most pensioners as the investment, inflation and longevity risk is passed to the insurer, BUT expensive
  - With-profit pension: can provide a pension at provides pension increases in line with inflation at a 15% lower cost than an inflation guaranteed pension but the product is complex

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Issues – matching assets

- Appropriate investment strategy leading up to outsourcing depends on the type of pension the Fund is securing
  - Level (or guaranteed escalation) pension: nominal bond of the same term as liabilities (hedge interest rate risk)
  - Inflation linked pension: inflation linked bond that hedges interest rate risk
  - With-profit pension: cash type return is price does not depend on interest rate
- Timing of change is important; don't want to be buying bonds when interest rates are cyclically low

Issues – benefits

- Ensure that the benefits provided by the policy correspond to that of the Rules
- For some smaller benefits the Fund may not have the data to price the cost (e.g. death benefit = consideration at outset less pensions paid). Fund a reasonable proxy to this benefit (if possible) and change the Fund rules to be consistent with this proxy
- Watch out for excess insurer cost when there are contingency benefits (e.g. a spouse's pension paid even if the member marries post retirement). Get details of the insurer's assumptions in pricing such benefits and negotiate these terms.

Issues – data

- Need to do a full data audit
- Usual practice is to do an in-source first and then a GN18 transfer once the data is cleaned up
- Contract to provide for price adjustment in respect of data issues prior to GN18 transfer; thereafter insurer carries the risk

Issues – contract terms for non-profit pensions

- Complex, but somewhat easier in respect of non-profit pensions (i.e. level, guaranteed escalation and inflation guaranteed pensions)
- Long term contract with the following key risks
  - Financial position of insurer deteriorates (worst case the insurer goes insolvent)
  - Adverse change in tax basis of insurer affecting the pension
  - Other adverse changes in legislation (e.g. limiting the annual pension in a high inflation environment)
  - No official inflation rate or inflation rate is clearly manipulated
- Option in policy to transfer to another insurer / change pension form

Issues – contract terms for with-profit pensions

- Very difficult – in addition to the solvency, tax and legislative matters the following additional issue arise
  - Full charging structure and the contractual ability of the insurer to change this during the period of the contract
  - Who carries the longevity risk?
  - How is the investment risk shared?
  - Optionality embedded in the contract terms (e.g. insurer can change asset allocation at their discretion)
- Greater protection now in the form of "treat consumers fairly" – insurer needs to provide policyholders with a written document covering the above

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Issues – pensioners wanting a living annuity

- The ideal is that members exercise a choice of an insurer life pension or a living annuity before the life pension outsourcing is done
- If the above cannot be achieved then need to negotiate favourable "surrender" terms for pensioners that elect the living annuity option. In practice this is likely to be the "market price" at the time and so pensioners are exposed to interest rate increases between the outsourcing date and the date the assets are transferred to a living annuity.

The difficult parts – many facets

- There are many streams of activity associated with an outsourcing
  - Project plan and co-ordinator
  - Sub-committee of the Trustees to make faster decisions
- Pricing is lot more complex than appears at first blush
  - Timing is an important consideration
  - Contract terms change the value of the pension
  - Comparing “apples with apples” requires suitable adjustments / valuing embedded options in the case of with-profit pensions
- Use expert advice
  - More of an investment problem than an actuarial problem
  - Get a good review of the contract (costs money but worth it)

The difficult parts – Insurer due diligence

- Level, guaranteed escalation and inflation guaranteed pension
  - Insurer's capital position and how this may change (planned reduction of capital to finance business development)
  - Insurer's long term and short term credit rating (get independent investment manager views on the accuracy of the rating)
  - Management philosophy and reputation of Chief Actuary
  - Contract terms (pricing, ability to vary the contract, escape clauses out of any guarantees, termination provisions)
  - Pension administration

The difficult parts – Insurer due diligence

- With-profit pension – as per non-profit pension but add
  - Level of smoothing reserves and how they will be released
  - Principles and Practice of Financial Management – should provide information on pension increase policy and how risk is shared
  - Asset allocation and conditions under which the asset allocation may change
  - Contract terms (capital charges, embedded options)

Closing comment

- In general outsourcing is not a good idea
  - Higher costs
  - Long term contract with no real flexibility to adjust to changing market conditions
  - Embedded options for insurer in with-profit pensions
  - Less than ideal alignment of interest
- The option price to the employer of a Fund pension is minimal
  - Trustees must be prepared to change the pension increase policy depending on the financial position of the Fund
  - Adopt a robust investment strategy with a focus on risk control

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Thank you

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