Irish Institute of Pensions Management

Sovereign Annuities

A presentation to the Irish Institute of Pensions Management

by Keith Burns

26 April 2012

Agenda

1. Background
2. Overview of sovereign annuities
3. Risks
4. Examples & uses
5. Issues for Trustees & Employers
6. Where to next

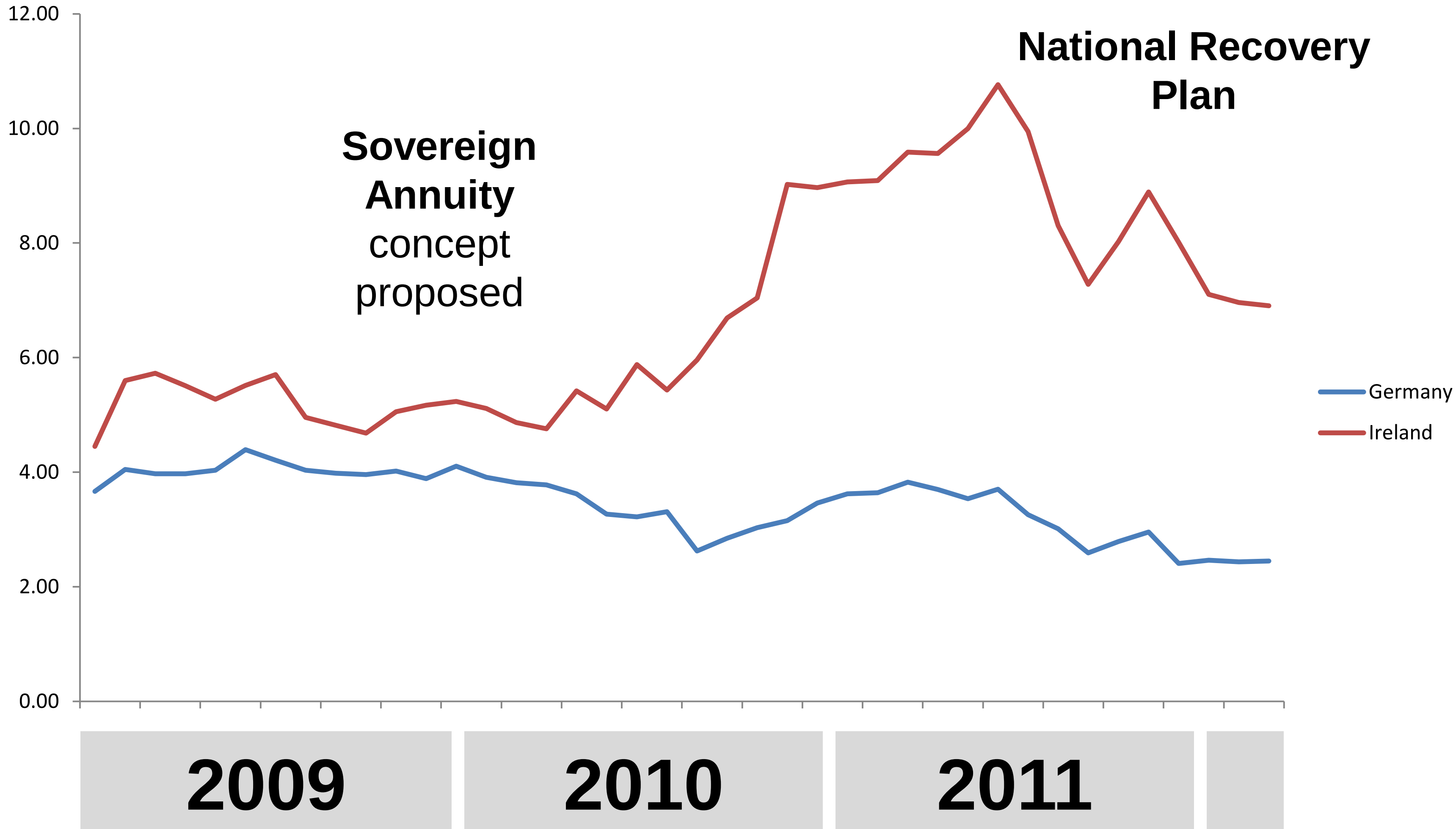
Background

- Sovereign annuity concept was first proposed early 2010
- Idea originally put forward by the IAPF and the SAI
- Key objectives:
    - A fairer balance between actives/deferred pensioners and pensioners
    - Improve DB sustainability at least in the short term
    - A practical solution that might actually get implemented
- Not a substitute for long term pension policy changes
    - Broader changes to address equity issues – e.g. pensioner priority
    - Broader changes to address DB sustainability – e.g. ‘core’ benefit approach
- A long gestation period!
    - Sovereign annuity products expected on the shelves by June 2012
- Some tough decisions lie ahead for Trustees/Employers

Background – Reaction to Sovereign Annuities

- Diverse views and comments:
  - *"Vital to our national recovery" – Eamonn O'Cuiv, Minister for Social Protection- December 2010*
  - *Concept is supported by both IBEC and ICTU*
  - *"The Society of Actuaries in Ireland welcomes the new flexibility that sovereign annuities will create….However, as noted, there are risks attached……" - SAI briefing statement*
  - *"It opens up new options for trustees in terms of reducing liabilities within the scheme, but it does add a new risk to pensioners. Trustees will have to consider their options very carefully." – IAPF*
  - *This is yet another example of the "insiders" in Ireland saving their own skins and giving the bill and the attendant risk to the "outsiders" – the ordinary Joe…..This initiative is yet another example of pyramid scheme thinking – David McWilliams*

Background –
10 year bond yields and timelines



Conventional vs Sovereign annuity

Conventional annuity	**Sovereign annuity**
Pays an income for the member's lifetime	Pays an income for life…but linked to specified bonds.
Payments are not reduced if the investments do not perform	Payments can be reduced due to an "event of non-performance"
	Lower Funding Standard liability
Invested in low-risk assets (e.g. German bonds)	Can be linked to bonds issued by any EU Member State

Sovereign annuity options

Buy-in	**Buy-out**
Annuity is owned by the Trust	Annuity is owned by the member
Immediate reduction in liabilities but Scheme retains credit risk	Immediate reduction in liabilities and risk is transferred to pensioner
Pensions continue to be paid from the scheme	Pensions paid by the insurer under individual annuities
Requirement to notify members	Detailed communication with members

Types of sovereign annuity

Ireland only

Price discount of 20-25% relative to conventional annuities

Assumes yield of 6% on NTMA coupon-only bonds

Eurozone Government Bonds

Price discount of 3-4% relative to conventional annuities

Assumes yield of 4% on bonds

Key risks

Benefit reduction/Cashflow risk

– Pensioner could receive no income for a period of months or years!

Credit risk

– Scheme or pensioner bears the credit risk

Illiquidity risk

– Annuity contracts cannot typically be surrendered

Concentration of risk

– Investment in Irish sovereign annuities or sovereign bonds would increase the scheme’s exposure to the Irish State

Reputational risk

Funding impact
Scenario 1: Buy-in all pensioner liabilities with a sovereign annuity

	Before €m	After* €m
Liabilities		
Pensioners (no increases)	100	80
Actives & Deferred (no increases)	50	50
Increases for Pensioners	30	24
Increases for Actives & Deferred	15	15
Total	**195**	**169**
Assets	120	120
Deficit	(75)	(49)
Annual cost of removing deficit	9.7	6.3
Cover for pensioners	100%	100%
Cover for Actives & Deferred	40%	80%

** Assumes reduction in liabilities of 20%*

Funding impact

Scenario 2: Buy-in pensions under €20K with a conventional annuity and pensions over €20K and increases with a sovereign annuity

	Before €m	After* €m
Liabilities		
Pensions up to €20K (no increases)	80	80
Pensions over €20K (no increases)	20	16
Actives & Deferred (no increases)	50	50
Increases for Pensioners	30	24
Increases for Actives & Deferred	15	15
Total	**195**	**185**
Assets	120	120
Deficit	(75)	(65)
Annual cost of removing deficit	9.7	8.4
Cover for pensioners	100%	100%
Cover for Actives & Deferred	40%	48%

** Assumes reduction in liabilities of 20%*

Uses of sovereign annuities

Termination/Restructuring

- Scheme winding-up in deficit with insolvent Employer
- An alternative to immediate benefit reduction using a Section 50 application
- Perhaps as part of a blended product (core conventional annuity with sovereign annuity top-up)

On-going/No re-structuring

- Sovereign annuity buy-out unlikely to be acceptable to Trustees
- Trustees may consider sovereign annuity buy-in or sovereign bonds if additional security available
  - Contingent asset
    - Letter of credit
    - Escrow account
    - Charge against an asset
    - Employer guarantee

Sovereign Bonds

- Schemes can hold Sovereign Bonds directly as an alternative to purchasing Sovereign Annuities and still avail of the Funding Standard reduction
- What is the definition of Sovereign Bond?
- In order to avail of Funding Standard reduction schemes must:
  - Commit to securing Sovereign Annuities on wind-up
  - Can only avail of the Funding Standard reduction to the extent they hold Sovereign Bonds
- Non-performance risk is retained by the actives and deferreds
- Likely to be an option favoured by larger schemes
  - May offer greater flexibility/value for money
- Critical outstanding issues are:
  - What pricing basis to value the pensioner liability?
  - What happens in a wind-up?

Trustee issues

- Balance of powers under Trust Deed & Rules
  - Contribution rule/Notice period
- Legislative protection
  - Where Trustees have acted ‘honestly and reasonably’
- Value for money
- Reputational risk
- Opportunistic Company-led wind ups
- Need to understand the risks and implications for all members
- Products are complex and unlikely to be readily understood by pensioners
- Clear need for legal advice

Employer issues

- Accounting impact
  - Settlement gain/loss recognised in a buy-out
  - Expected return on assets will change in a buy-in
- Impact on long term funding costs
- Another incentive towards de-risking
  - Recent IAS19 accounting changes
  - Introduction of risk reserves
- Reputational risks
- Sovereign annuity buy-in or direct holdings of Sovereign Bonds would still leave Employer exposed to risk of higher contributions if bonds do not perform

General issues

- Trustee job will get even harder
- Significant reputational risks for pension industry
    - Company versus Trustee advice
- Fundamentally alters DB promise
    - May improve the sustainability of DB schemes
- Are there better ways to address equity and sustainability issues?
    - Address pensioner priority issue
    - ‘Core’ benefit approach

Where to next?

- Products expected to be available by June
- Guidance still awaited on Funding Standard discount available where Scheme holds sovereign bonds directly
- Wide range of options for Trustees & Employers to consider
- Sovereign Annuities and Bonds will form a key part of Funding Proposal discussions