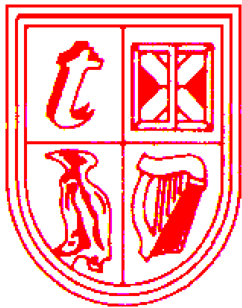
A new approach to funding pensioner liabilities using *Sovereign Annuities*

May 2010



Society of Actuaries in Ireland

Irish Association of Pension Funds

Status

- This concept has been originated by the Society of Actuaries in Ireland (SAI) and the Irish Association of Pension Funds (IAPF).
- It should be considered in the context of more strategic pension reform proposals both organisations have already made.

The Current Situation

- The majority of DB schemes are under significant financial stress.
- The total pensioner liability of schemes is estimated at €20bn to €30bn.
- Annuity costs are the basis for
  - Testing the solvency (pension obligations) of ongoing schemes under the Minimum Funding Standard
  - Buying out pensions for schemes being wound up
- Annuities are priced off German bonds (because of their duration availability and security rating) and are subject to capital adequacy provisions
- Annuities are therefore 15% to 20%* more expensive than would be the case if their pricing was based on Irish sovereign bonds and the need for capital adequacy provisions was eliminated/reduced.
- While PIPS does address these issues it only alleviates the position of a small minority of schemes because, for EU competition law reasons, it is only available where an insolvent scheme is being wound up and the sponsoring employer is also insolvent.

* SAI analysis based on an Irish/German yield gap of 1.4%.

The Basic Concept

To enable schemes to satisfy their pension obligations by allowing them to utilise the higher yields available from Irish sovereign bonds.

The merits of this are

- The **alleviation of the deficits** of many DB schemes allowing them breathing space to address other issues
- A significant (€bns) **new cost neutral (or better) source of funding** for the Exchequer*
- An **increase in active member pension values** typically from 40c to 60c in the € (see Appendix 2)
- A **reduction in cash calls** for employers and employees
- **Less drastic benefit reductions** for the schemes currently conducting strategic benefit reviews

*The funds raised will be on no worse terms than we are currently borrowing on the international markets

Implementing the Concept – Proposed Approach

- Introduce a new type of annuity - provisionally called a ***Sovereign Annuity***

- ***Sovereign Annuities*** to
  - Be manufactured and sold by commercial insurers.
  - Be invested in and priced off Irish sovereign bonds*
  - Include a clause providing that annuity payments may be adjusted in the very unlikely event that the underlying sovereign investments do not perform as anticipated

- ***Sovereign Annuities*** to become an acceptable alternative to conventional annuities for
  - Satisfying the Minimum Funding Standard
  - Buying out pensioner liabilities for both ongoing and winding up schemes

- Schemes as a consequence of this measure will
  - De-risk by building up portfolios of matching Irish sovereign bonds (perhaps with associated longevity insurance)
  - Buy ***Sovereign Annuities*** in the commercial market

* As indeed was the case before we joined the euro

Implementing the Concept – Required Enabling Measures

Bond Supply

- NTMA to make available a supply of suitable bonds (average required duration 12 to 15 years)
- Ideally these will be structured in coupon only form
- These bonds will be freely available to all market participants

Pensions Legislation Changes

- The Minimum Funding Standard to be amended to explicitly deem ***Sovereign Annuities*** as an acceptable measure of a scheme's solvency
- An amendment overriding scheme provisions to the effect that ***Sovereign Annuities*** will be an acceptable means of discharging trustees' obligations to pensioners*

*There is already some precedent for legislation overriding a Scheme's rules in respect of obligations to pensioners in the event of a wind-up.

Summary of Stakeholder Benefits

	The State	Active & Deferred Members	Pensioners	Employers	Trustees
Helps alleviate the current pensions crisis at little or no cost	√	√	√	√	√
May slow momentum towards reducing DB commitments	√	√	√		√
Reduces corporate cash flow requirements	√			√	
Makes funding proposal process less onerous				√	√
Makes de-risking more affordable thus increasing security for members		√	√	√	√
Higher transfer value payments and increased possibility of allowing early retirements		√		√	
Higher payouts possible in actual wind-ups		√	√		√
Reduces risk of fall back of Pensions crisis (Robins) on the State	√				
Opens up significant source of new funding for the State	√				
Avoids competition issues	√				

More on the Effect on Pensioners

- In the event of non-payment of a coupon, the value of benefits could be reduced to reflect this:
  - In the case of a scheme that has been wound up and which purchased ***Sovereign Annuities***, benefits of pensioners would be adjusted. Insurers issuing ***Sovereign Annuities*** will be allowed contractually to modify/reduce payments in the unlikely event that the commitments under the underlying Irish sovereign bonds are not met.
  - In the case of an ongoing scheme, benefits of all members could be adjusted
- The value of any adjustments could not exceed the unpaid coupon(s)
- This is arguably not dissimilar to the current position of
  - Public service pensioners; and
  - Depositors under the State bank guarantee scheme.
- However, pensioners could benefit in other ways from this change. For example, their prospect of discretionary and guaranteed increases will be enhanced

Time is of the Essence

- There is an opportunity to make a change which could have wide reaching and significant positive impact for many different stakeholders including the State
- There is however an urgency involved as companies and trustees are developing plans to deal with their deficits right now

Appendix 1
Addressing Possible Concerns

Addressing Possible Concerns

Possible Concern	Counter View/ Mitigation
That this constitutes a "bail out" of private sector pensions	This is incorrect. The cost will be the same as issuing conventional bond
That the Exchequer will be required to fund at longer than its preferred duration at too high a yield gap	Substantial funding has already been raised at the same average duration
That DC schemes are excluded	Should be extended to retirees and individuals who have deferred annuity purchase
That it might be subject to an EU challenge and insurance law requirements	Very unlikely as opportunity will exist for all commercial insurers
That the fiscal and banking crisis is a bigger priority and there are insufficient resources for another initiative of this magnitude	The effort required in terms of legislative change would be marginal

Appendix 2
Impact on Different Schemes

Funding Pensioner Liabilities

Impact on Different Schemes

	Mature Scheme	Typical Scheme	Immature Scheme
Pre Crash	€100m Assets €70m Pensioner Liabilities (conventional annuity cost) and €30m Active Liabilities **100% active coverage**	€100m Assets €50m Pensioner Liabilities (conventional annuity cost) and €50m Active Liabilities **100% active coverage**	€100m Assets €30m Pensioner Liabilities (conventional annuity cost) and €70m Active Liabilities **100% active coverage**
Post 30% Fall in Value	€70m Assets €70m Pensioner Liabilities (conventional annuity cost) and €30m Active Liabilities **0% active coverage**	€70m Assets €50m Pensioner Liabilities (conventional annuity cost) and €50m Active Liabilities **40% active coverage**	€70m Assets €30m Pensioner Liabilities (conventional annuity cost) and €70m Active Liabilities **57% active coverage**
After giving scheme access to 20% saving	€70m Assets €56m Pensioner Liabilities (***Sovereign Annuity*** cost) and €30m Active Liabilities **47% active coverage**	€70m Assets €40m Pensioner Liabilities (***Sovereign Annuity*** cost) and €50m Active Liabilities **60% active coverage**	€70m Assets €24m Pensioner Liabilities (***Sovereign Annuity*** cost) and €70m Active Liabilities **66% active coverage**