Legacy defined benefit scheme liabilities: analysis

*By Malcolm Small - July 2006*

There is no doubt that many companies saddled with closed defined benefit pension schemes are ready to fall at the feet of anyone prepared to take the things off their hands. What with funding challenges, reports to the Pensions Regulator, balance sheet issues where under-funding exists and resultant restraints on corporate activity, it is no wonder that some companies now describe themselves as "Pension Fund Managers with a business attached". And with the emergence of new operators prepared to do just that, the arrival of a whole new sector effecting bulk buy-outs of defined benefit scheme liabilities seems certain.

There is also emerging under-capacity in the individual annuity market going forward, so happy times could be here again for financial services. At least three new players have announced their intention to enter the market, with existing, capital-rich players openly looking at it. The new players are backed by private equity houses for the most part, representing the wall of PE money currently looking for a home yielding the double digit returns required. There will no doubt be others.

"The real open question is longevity"

Strangely, this was a vibrant market that those of us with longer memories will recall from about 25 years ago. In those days, bulk buy-outs were mainstream business transacted by many insurers. Yet in the last two years there have really only been two players – the Prudential and Legal & General.

So what happened?

Just like individual annuity business, this is a price-sensitive market where the assessment of longevity, amongst other factors, determines the rate at which you will take on the business and hence the price the client has to pay to make you take it away. Clearly, the less the client has to pay the better, forcing market players to take greater risks in terms of their longevity assumptions. So, as competition increased, prices got increasingly unsustainable, longevity experience got better (or worse, depending on whether you are a human being or an insurance company) and players left the market to nurse their losses.

Clearly, the same thing could happen again.

However, there is now much greater prudential supervision by FSA, which should mitigate the risks of companies taking on too much of a liability at too low a price. And there is undoubtedly money to be made from investment management and efficiency gains.

The real open question is longevity.

Longevity seems to be on the increase in the UK, with the monarch expected to be signing 25,000 centenarian greetings a year by 2030. Current trends could even accelerate with the introduction of anti-ageing drugs based upon genetics.

If, in taking on a scheme, you have assumed an average life expectancy of 85, if it turns out to be 90, you have a problem based upon an actuarial risk judgement made over 20 years before, and no way out.

It will be interesting to see how the new players plan to hedge this risk.