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PENSION BUYOUTS: WHAT CAN WE LEARN FROM THE UK EXPERIENCE?

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Introduction

Over the past half century, employer-sponsored defined benefit (DB) pensions have been crucial sources of retirement income and security. However, the popularity of DB pensions in the private sector has dwindled, and competitive pressures may drive DB plans from the private sector altogether. Significantly, this burden is not only a US phenomenon, as UK private plan sponsors are also struggling to manage their DB pension commitments. Nonetheless, a fundamental difference of opinion exists between UK and US policymakers about how to address the decline of the DB system.

In the United Kingdom, DB stakeholders have accepted the plans' decline as inevitable and are now promoting alternative mechanisms to shore up retirement security. For example, in the Pensions Act of 2008, the UK government mandated that employers enroll eligible employees into a workplace pension and created a new second pillar pension institution, the Personal Accounts Delivery Authority (PADA), to facilitate the new policy. In addition, UK policymakers, and indeed most DB stakeholders, have endorsed the use of pension buyouts as a way to manage the decline of this once important institution.¹ A buyout al-

lows firms to pay an insurance company a fee to take over the assets and liabilities of their plan, thereby freeing them from their DB obligations.² As such, UK policymakers perceive buyouts to be part of the process of unwinding an unsustainable institution, and most see the rising popularity of pension buyouts as a direct response to the increasingly burdensome nature of DB pensions.³

Conversely, policymakers in the United States are more interested in *stopping* the decline of DB plans than *managing* the decline. They prefer to think about ways to extend this institution's life rather than manage its death, and this attitude colors their response to pension buyouts.

This *brief* describes in more detail why buyouts are embraced in the United Kingdom but viewed with a mix of suspicion and ambivalence in the United States.⁴ The first section determines what is driving the UK buyout activity. The second section evaluates the outlook for the UK buyout market. The third section then contrasts UK and US policymakers' views on the decline of the DB system and the utility of buyouts. The conclusion draws implications for US policymakers from the UK experience.⁵

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The UK Buyout Market

Prior to 2004, companies settled pension obligations in the United Kingdom in two ways. If solvent, the firm paid the benefits out as planned over the long term until the contracts “expired” upon the beneficiaries’ death. If insolvent, the firm would buy a bulk annuity covering many lives from a regulated insurance company, which would sever the relationship between plan members and the sponsoring employer.

Originally, companies facing insolvency sought buyouts at the behest of either a regulator or a court, since the UK did not have a government insurer to take over pension obligations for bankrupt firms. A disappearing plan sponsor would use the buyout as a mechanism to ensure as much payment of the pension benefits as possible with the available assets. Given that bankruptcies among plan sponsors remained relatively infrequent, the UK market for ‘insolvent buyouts’ was small, turning over roughly £1-2 billion pounds per year for the better part of two decades.⁶ To place this figure in context, the total value of DB pension liabilities in the United Kingdom is approaching £1 trillion pounds.⁷

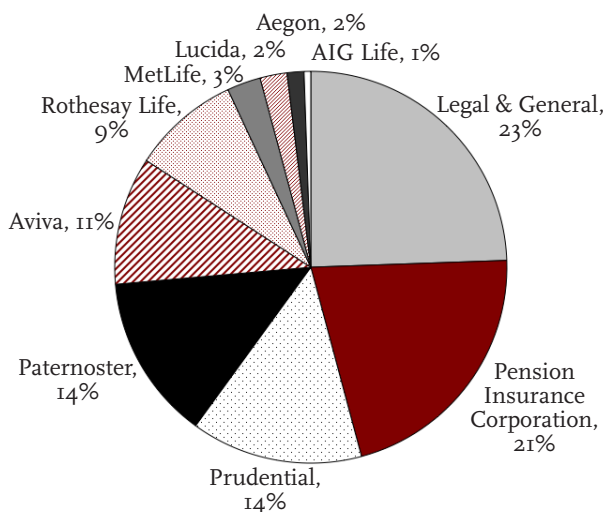
In 2004, the buyout market was set for a shake up, as the Pensions Act established the Pension Protection Fund (PPF). Based on the US Pension Benefit Guaranty Corporation, UK policymakers designed the PPF to protect pension benefits in situations where the sponsor failed and did not have enough money in the pension scheme to fund 100 percent of benefits. Since insolvent firms typically have underfunded pensions, the expectation was that the PPF would crowd out the private insurance companies offering buyouts. However, despite the creation of the PPF, transactional volume surged, increasing nearly fourfold to £8 billion between 2006 and 2008. The changing nature of the DB pension obligation resulted in new demand (and supply) for buyouts.

Interviewees in the United Kingdom explicitly linked the demand for buyouts to the growing DB burden. According to UK DB pension stakeholders, buyouts allow companies to get out from underneath their DB liabilities through a one-time charge and get on with the core operations of their business. “The company escapes volatility to its profit and loss account, levies to the Pension Protection Fund, and asset management fees on pension assets.”⁸ Given that insolvent buyouts had existed for years, this raises the

question as to what changed. Apparently, the impetus for solvent buyouts was the accounting rules and regulations that came into effect around 2005.⁹ Solvent firms decided that a buyout would be easier and less costly than compliance with the new rules and regulations.¹⁰ In sum, market demand has grown significantly – from a handful of insolvent companies with DB pensions to potentially all UK plan sponsors looking to offload what they perceive to be a burdensome liability.¹¹

The supply side has changed as well. In the early 2000s, only two providers offered buyouts: Legal & General and Prudential. However, potential buyout providers noticed that demand was shifting from insolvent to solvent buyouts thanks to the additional burdens created by the 2004 Pensions Act and the new accounting rules. A market in which all DB pension plan sponsors were potential clients was much more enticing for buyout providers than a market based on the handful of insolvent firms forced into buyouts. A commensurate rush to tap this new demand for solvent buyouts ensued. Today, interviewees placed the number of firms actively *interested* in providing buyouts in the United Kingdom at between 12 and 15. (See Figure 1 for active participants in 2008).¹²

FIGURE 1. MARKET SHARE OF PENSION BUYOUT PROVIDERS IN THE UNITED KINGDOM, 2008

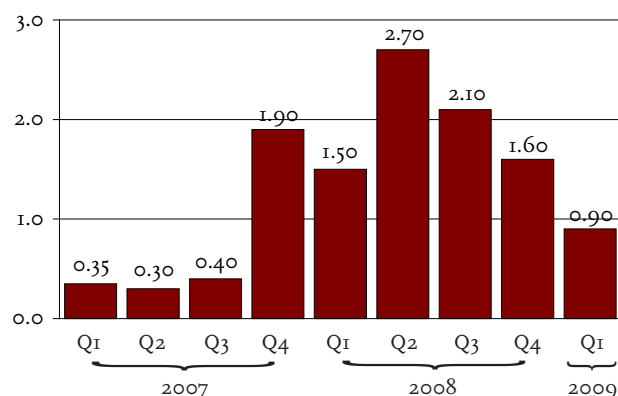


Source: Lane Clark & Peacock (2009).

The Outlook for the UK Buyout Market

The scene was set for a dramatic expansion in the UK buyout market in 2008 (see Figure 2). New entrants drove the price down just as demand among plan sponsors was spiking. First, the funding level of the plans temporarily improved, making it an opportune time for many plan sponsors to transfer their pension burden. Second, bond yields used to value liabilities increased, so the buyout prices came down. The question is whether the resulting surge in activity in 2008 was a product of a confluence of rare phenomena, or the beginning of an increasingly large market in solvent buyouts.

FIGURE 2. INSURED PENSION BUYOUT ACTIVITY IN THE UNITED KINGDOM, BILLIONS OF £, 2007-2009



Source: Punter Southall (2009).

UK interviewees generally viewed the long-term prospects for insured buyouts as favorable. Nonetheless, three key constraints will limit this market's growth in the short- to medium-term: 1) underfunding; 2) capacity; and 3) volatility.

Underfunding

If a pension plan is underfunded, the plan sponsor has to pay out a much larger cash contribution to do the buyout. Since the recent crisis has sent many plans into a severe state of underfunding and plan sponsors can ill afford a large one-time charge for a buyout at this time, this is a major constraint. So, while plan sponsors may still be interested in doing a buyout, many simply cannot afford to.

Capacity

Because insurers used so much of their available capital in 2007 and 2008, capacity constraints are limiting the ability of these firms to do all of today's potential transactions. According to one buyout provider, "There is not enough capital to fill demand for the insured solutions; pipelines are huge at the moment." Indeed, one of the largest buyout providers said they were turning down up to 90 percent of their requests for quotes. They simply do not have the capital to do all the deals that are available.¹³

Volatility

The conditions in the financial sector are such that pricing deals has become very difficult; insurers are reacting cautiously. Also, pension plans have adopted a "wait and see" attitude on buyouts due to the deterioration in the global economy.¹⁴

Therefore, insured buyout activity has declined in 2009.¹⁵ However, the recent financial crisis may have actually increased corporate interest in buyouts. With huge drops in asset values, the market volatility offers yet another illustration of how vulnerable plan sponsors are to exogenous shocks. In fact, several UK pension consultants indicated that most of their clients were at least preparing their data to be able to do a buyout if the opportunity presents itself.¹⁶ Moreover, recent evidence suggests pension freezes and closures, which are preconditions for full buyouts, are accelerating in the United Kingdom.¹⁷ Overall, the long-term outlook for the buyout market remains favorable.

DB Pensions: A Difference of Anglo-American Opinion

Both UK and US plan sponsors are struggling to manage their DB commitments. However, a fundamental difference of opinion exists between UK and US policymakers about how best to address the issue. In the United Kingdom, policymakers perceive buyouts to be part of the process of unwinding an unsustainable institution:

- Then UK Minister for Pension Reform Mike O'Brien said in 2008, "A clear consensus has emerged. Insured buyouts are often very sensible and effective mechanisms for securing the pensions promise. An insured buyout can give

members comfort that their benefits are backed by the safeguards provided by regulation, while providing employers with the certainty that they have met their commitments in full.”¹⁸

- In addition, one UK official noted during an interview, “As a society, we’ve moved on from defined benefit pensions...albeit recognizing that defined contribution pensions are incapable of providing similar benefits. Buyouts are part of the process of moving on.”¹⁹
- One UK regulator even said during an interview, “If every scheme that could have done a buyout a few years ago did, we’d have less to worry about.”²⁰
- In short, buyouts in the United Kingdom are considered the last (or penultimate) chapter in the history of private DB pensions.

In contrast, US policymakers view buyouts not as the symptom of an increasingly burdensome institution but rather as a threat to the DB institution itself.²¹ As the U.S. Government Accountability Office recently noted, “Opponents to buyouts contend that...a frozen plan that remains within the firm has at least a chance of being ‘thawed,’ especially within a collective bargaining agreement.”²² Though risky ‘non-insured buyouts’ give US policymakers the most pause, buyouts in general are not appreciated. Our discussions with three separate individuals in the US government about pension buyouts illustrated that they were not ready to give up on DB plans:

- “I’m not sure we want to give employers an easy out. How does that preserve the DB system?”²³
- “Instead of allowing companies to dump their pension liabilities, we need to start asking questions about our accounting and regulations governing pension plan sponsors.”²⁴
- “...We don’t want to do anything that is going to make it easier for plan sponsors to dump their DB pensions.”²⁵

In sum, US policymakers are less interested in managing the decline of DB plans than they are in stopping the decline.²⁶

Conclusion

In recent years, the UK pension buyout market has experienced considerable growth. While various market factors played a role in this growth, the increasingly burdensome nature of DB pension provision has been a major one. Buyouts are no longer reserved only for insolvent firms, as they were pre-2004, but have instead become a way for solvent sponsors to offload a costly and risky obligation. Though current market conditions are not favorable, the long-term prospects for the UK buyout market are quite good.

While US plan sponsors face many of the same burdens as their UK counterparts, the development of a UK-style insured buyout market in the United States is unlikely (at least in the short- to medium-term). This assessment is primarily because US policymakers believe private DB pensions are salvageable.

Endnotes

1 As Craig (2008) explains, “The term pension buyout usually refers to an insured buyout, where a trust-based occupational DB pension scheme transfers the responsibility for its pension obligations from the trust set up to administer the scheme assets to a regulated insurance company, in return for a premium payment. Following this, pensions are paid by the insurance company, rather than the trust.”

2 While UK non-insured buyouts attracted considerable attention, no new transactions have taken place since 2007. As such, this *brief* focuses on the rise of the insured buyout market.

3 Given that two thirds of all UK DB plans are closed, this view seems sensible.

4 This research adopts a multi-method approach grounded in qualitative, interview-based techniques and case studies. Specifically, close-dialogue, which refers to interviews on a confidential basis with no-citation rights directed by a pre-determined set of questions, is used to construct a coherent narrative for the market’s development as well as certain relevant corporate and transactional case studies. The observations that underpin this *brief’s* analysis were collected and cross-checked during interviews with 37 individuals across 27 organizations in New York, Washington, D.C. and the greater London area. These individuals are buyout providers, industry lobbyists, policymakers, regulators, consultants, actuaries, lawyers and pension executives. For further details on the methodology, see Monk (2009).

5 The UK DB pension system is different from the US DB system. For example, the power of the Pensions Regulator, the power of UK trustees and even the varying reversion tax rates are all important differences. Moreover, differences between the UK insurance industry and the US insurance industry are significant, such as the weaker insurance guarantees in the United States. Finally, clear cultural differences between the two countries exist, such as the rules-driven approach in the United Kingdom and the legalistic approach in the United States. As such, drawing implications for the US from the UK experience can be difficult. Nonetheless, as this *brief* explains, certain UK experiences do have relevance in the United States.

6 Author’s personal communication with one of the oldest buyout providers in the United Kingdom.

7 See Pension Protection Fund (2009).

8 Blake, Cairns, and Dowd (2008).

9 See Munnell and Soto (2007); Monk (2008); and Jones, Hunter, and Herbert (2008).

10 In many ways, the buyout decision is very similar to an investment decision. It is a decision about how best to apply the pension assets to ensure that liabilities are paid (see Arter, 2008).

11 According to a PricewaterhouseCoopers survey, 35 percent of the closed DB pension plans (which represents two thirds of all UK DB plans) were considering a buyout of some kind in 2007. See Timmins (2007).

12 While insurers in the United Kingdom are highly regulated, capital requirements – based on models built by the insurer and approved by the Financial Services Authority (FSA) – are heterogeneous. According to a UK government official familiar with buy-out models, pricing is “a bit of a black art.” This flexibility allowed for a highly competitive pricing environment in 2007 and 2008.

13 Significantly, the introduction of UK government longevity bonds could be a way of overcoming the insufficient capital in the insurance industry since this would allow some of the risk to be passed on to capital markets (see Blake et al., 2009).

14 See Lane Clark & Peacock (2009).

15 Indeed, a recent report by Pension Capital Strategies shows that the first quarter of 2009 was well off the 2008 pace, even if £1 billion worth of buyouts were still transacted (Pension Capital Strategies, 2009).

16 Author’s personal communication.

17 See Stapleton (2009)

18 Cited in Lane Clark & Peacock (2008).

19 Author’s personal communication.

20 Author's personal communication.

21 These transactions first attracted attention in the United States when financial services firms considered importing the non-insured variety of buyouts that took place in the United Kingdom in 2007. However, these controversial transactions have since fallen out of favor in the United Kingdom, and an IRS Revenue Ruling (2008-45) made them illegal.

22 See U.S. Government Accountability Office (2009).

23 Author's personal communication.

24 Author's personal communication.

25 Author's personal communication.

26 See Monk (2009) for more details.

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