



Society of Actuaries in Ireland

Sovereign Annuities

September 2012

Background

- Sovereign annuity concept was first proposed late 2009, 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 very soon
- Some tough decisions lie ahead for Trustees/Employers

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*

Sovereign Annuities

Payment of the annuity is linked directly to the payment of specified bonds. (**“Reference Bonds”**)

- Bonds issued by Ireland or any other Member State of the EU

Payments can be reduced due to an **“event of non-performance”**

- Capital and/or coupon payments are not paid on the due date
- Terms of a reference bond are varied such that the insurer views the value of payments due under the bond as reduced
- Would hope for a common approach from insurers

Payments will be restored if there is an **“event of recovery”**

In order to avail of Funding Standard liability reduction (buy-in basis) schemes must:

- Commit to using Sovereign Annuities on Wind Up
- Can only avail of the Funding Standard reduction to the extent they hold Sovereign Annuities
- Meet disclosure requirements

Sovereign Annuities

- Policies can be owned either by
 - the Trustees – a “buy-in”
 - the member – a “buy-out”

Buy-in:

- Purchase of bulk annuity (and/or deferred annuity) held by trustee **as an investment**
- Relationship between member and scheme **does not change**

Buy-out:

- Purchase of individual annuities (and/or deferred annuities), where each forms a **single policy between member and insurance company**
- Relationship is then **between member and insurance company** (not the scheme)

Key Risks

Benefit reduction/credit risk

- Scheme (buy-in) or pensioner (buy-out) bears the risk
- If “Buy out” the pensioner could receive no income for a period of months or years!

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

- Change in nature of promise to members?
- Due to pensioners receiving suspension of pension

Impact of sovereign annuities on funding position (example 1)

Current position

	€m
Liabilities	
Pensioners	100
Actives & Deferred	50
Total	150
Assets	120
Deficit	(30)
Cover for pensioners	100%
Cover for Actives & Deferred	40%

Sovereign annuities for all pensioners

	€m
Liabilities	
Pensioners	80
Actives & Deferred	50
Total	130
Assets	120
Deficit	(10)
Cover for pensioners	100%
Cover for Actives & Deferred	80%

* Assumes reduction in pensioner liabilities of 20%

Sovereign annuities used for 100% of the Pensioner liability

Impact of sovereign annuities on funding position (example 2)

<u>Current position</u>		<u>Sovereign annuities for 'non core' pensioner liability</u>	
	€m		€m
Liabilities		Liabilities	
Pensioners	100	Pensioners	93
Actives & Deferred	50	Actives & Deferred	50
Total	150	Total	143
Assets	120	Assets	120
Deficit	(30)	Deficit	(23)
Cover for pensioners	100%	Cover for pensioners	100%
Cover for Actives & Deferred	40%	Cover for Actives & Deferred	54%

* Assumes reduction in pensioner liability cost for excess of 20%

Sovereign annuities used for pension in excess over €10,000

Potential uses of sovereign annuity

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)

Ongoing / No restructuring

- Sovereign annuity buy-out unlikely to be acceptable to many Trustees
- Notable exceptions could be where the Sponsor is effectively the State or where the Sponsor's covenant is seen as substantially weaker than the State's
- Trustees may consider sovereign annuity buy-in if additional security available (eg contingent asset)

Valuing Sovereign Annuities

- Actuarial Funding Certificate (AFC) or Annual Statement
 - Only an issue on buy-in
 - Value both the Sovereign Annuity and corresponding pension in payment on current market Sovereign Annuity market basis
 - Omit pensions in payment and corresponding sovereign annuity from calculation
- Funding Proposal
 - Value in a similar manner over the course of the Funding Proposal

Sovereign Bonds

- Schemes can hold Sovereign Bonds directly as an alternative to purchasing Sovereign Annuities and still avail of Funding Standard reduction
- What is the definition of Sovereign Bond?
 - EU sovereign bond
- In order to avail of Funding Standard reduction schemes must:
 - The Trustees must formally resolve to purchase sovereign annuities on a wind-up and review this decision on an annual basis
 - Trustees must take advice on this strategy
 - Trustees must communicate to membership and representative Unions
- Non performance risk is retained by the Scheme
- Legislative complexities mean that Sovereign Bonds are unlikely to be popular
- How is transition to Sovereign annuities managed on Wind Up?

Valuing Sovereign Bonds

- Actuarial Funding Certificate (AFC) or Annual Statement

- Where there is an active SA market by subtracting:
 - » The realisable value of the bond **from**
 - » The cost of purchasing, on a traditional annuity basis, the pension that could be purchased on a SA basis by the realisable value of the bond
- Where there is no active sovereign annuity market:
 - » Need to deconstruct your bond portfolio and look at on a 'bond by bond' basis, this may be more difficult where bonds are held indirectly
 - » Provided each bond has a maturity of > 10 years later than the effective date a reduction may be applied
 - » Reduction factor is calculated by reference to the difference between the yield on the bond and the yield on the 3.25% Bund of 2010 (2042)

Yield difference	Percentage
Less than 3%	0%
Equal to or more than 3%	20%

- Funding Proposal

- Actuary can only avail of pricing reduction in accordance with Section 53B basis if the scheme holds EU sovereign bonds at the date of certifying the Funding Proposal, of a value not less than the value of all pensions in payment under the Scheme.
- Where the pricing reduction is greater than 5%, pricing reduction must reduce uniformly to 5% on 31 December 2023.
- Where the pricing reduction is less than 5%, pricing reduction will remain unchanged indefinitely

General Issues

- Trustees job will get even harder
- Another incentive towards de-risking
 - Recent IAS19 accounting changes
 - Introduction of risk reserves
- Significant reputational risks for pension industry/advisers
 - Company versus Trustee advice
- Fundamentally alters DB promise
 - May improve the sustainability of DB schemes
- Yield reversion
- Are there better ways to address equity and sustainability issues?
 - Address pensioner priority issue
 - 'Core' benefit approach