THE SOCIETY OF ACTUARIES IN IRELAND

BRIEFING STATEMENT

Sovereign Annuities

This briefing statement has been issued by the Society of Actuaries in Ireland in order to provide information on a "sovereign annuities" concept that has attracted media attention recently.

Background

The majority of Irish defined benefit pension schemes are under significant financial stress. It has been estimated that 80% of them currently fail the minimum funding standard (*this standard is described below*).

In December 2008, the Society of Actuaries in Ireland and the IAPF made a series of proposals to government on legislative changes aimed at helping employers and trustees to address the issue of the current deficits in defined benefit pension schemes. One of the proposals was the establishment of a state annuity option for insolvent schemes of insolvent employers, and we submitted a more detailed report on options in this regard in April 2009. Both submissions are available on the Society's website, at https://web.actuaries.ie/press/submissions.

The Department of Finance has since established the "Pensions Insolvency Payment Scheme", which aims to reduce the pensioner liabilities of defined benefit schemes which wind up in deficit following employer insolvency.

Building on the efforts that contributed to this initiative, we have continued to explore ways of improving the viability of defined benefit schemes. In recent months, again jointly with the IAPF, we have had discussions with various Government departments and agencies about the possibility of substituting a new type of annuity, provisionally called a "sovereign annuity", for conventional annuities for the purposes of the minimum funding standard and for securing pensions on scheme wind-up and as members retire in ongoing schemes.

Minimum funding standard

The minimum funding standard is a legislative requirement under which schemes must have sufficient assets in place to secure pensioner liabilities and other members' accrued benefits in the event of scheme wind-up. Schemes that do not have sufficient assets to satisfy the minimum funding standard must prepare funding proposals to address this situation in a timely manner and submit them to the Pensions Board for approval.

For the purpose of the minimum funding standard, the liability in respect of pensions in payment is determined by reference to the cost of buying annuities in the insurance market. Effectively, this means that the discount rate used to value future pension payments is dictated in large part by the yield on German sovereign bonds, as they are widely used by insurers to price annuity products and match the liabilities because of their duration availability and security rating. The funding deficits currently being experienced by most defined benefit schemes have been exacerbated by the current low yield on German sovereign bonds.

"Sovereign Annuities"

Sovereign annuities would differ from conventional annuities in that payments would be linked to the payments under Irish sovereign bonds. They would be invested in and priced off Irish sovereign bonds. To make this feasible, it would be necessary for the NTMA to issue coupon-only bonds of appropriate duration to match the liabilities under the annuities.

Because of the current yield difference between Irish and German sovereign bonds, sovereign annuities would be cheaper than conventional annuities. The reduced cost of securing pensioner liabilities would mean that schemes would have more funds available to provide benefits for active and deferred members[1]. This would mitigate the effect of the "priority rule" under which pensioners have first call on the assets in the event of scheme wind-up. Partly because of the priority rule, many schemes are currently in the situation that the assets available for active and deferred members' accrued benefits are very low and would secure only a small proportion of the benefits. The introduction of sovereign annuities has the potential to increase the assets available for active and deferred members' accrued benefits by 50% or more for many schemes.

Implementing the Sovereign Annuity Concept

As regards implementation of the sovereign annuity concept, there are four planks to be addressed:

- Plank 1: On **scheme wind-up**, allow trustees to discharge obligations to pensioners by buying sovereign annuities.

- Plank 2: For the purposes of the **minimum funding standard**, allow trustees to value obligations to pensioners by reference to the cost of sovereign annuities. This would be a logical corollary to Plank 1.

- Plank 3: **Ongoing schemes** - To promote the sustainability of pension schemes, and maintain a consistent regulatory framework for ongoing schemes and those in wind-up, allow trustees of an ongoing scheme to discharge the obligation to a member who reaches retirement age by purchasing a sovereign annuity in the member's name. This is likely to appeal to small to medium sized schemes.

[1] Active members are members who are currently employed by the scheme sponsor. Deferred members are members who have left the employment of the scheme sponsor and have not yet reached retirement age.

- Plank 4: **Ongoing schemes –** For larger schemes, retaining pensioner liabilities on the scheme's balance sheet may be preferable to transferring them to an insurance company. Recognising this, and to avoid market distortions, allow trustees of an ongoing scheme to match pensioner liabilities by investing in Irish sovereign bonds (or sovereign annuities in the name of the scheme) on the basis that they would have the right to vary scheme benefits[2] if payments under the bonds (/annuities) were varied. This is likely to appeal to medium to large schemes.

The four planks are interrelated; therefore, implementing only some parts of the concept could have unintended consequences and could cause distortions in the pensions and annuity markets.

Consequences

We expect that consequences of introducing the sovereign annuity concept would include the following:

(a) It would help schemes to meet their minimum funding standard obligations. It would give them breathing space to address issues relating to long-term affordability and sustainability of benefits in an orderly and robust manner. Potentially, it would allow them to make decisions in this regard in the context of the government's proposed new National Pensions Framework.

(b) In the case of scheme wind-ups, the reduced cost of securing pensioner liabilities would mean that more money would be available for active and deferred members' benefits.

(c) For all schemes, the increase in assets available for active and deferred members would create greater equity between different categories of members than applies at present.

(d) The level of security for pensioners' benefits may be reduced – but it would be consistent with the level of security of, for example, State pensions, public sector pensions in payment, and indeed depositors covered by the State bank guarantee scheme. Also, because cash resources would be released, the prospect for some pensioners of both discretionary and guaranteed pension increases being paid would be enhanced.

(e) The initiative would generate a significant new source of exchequer funding as it would encourage trustees to invest in Irish sovereign bonds as a matching asset for minimum funding standard and pensioner liabilities. If and when Irish sovereign bond yields revert to norms, the capital value of the asset will rise, matching a corresponding increase in the liability (/ the cost of sovereign annuities). The value of schemes' obligations to pensioners is estimated to be between €20bn and €30bn, only a small proportion of which is currently matched by Irish sovereign bonds.

[2] It would be logical to include all members' benefits in scope here. Active and deferred members benefit from the initiative, in that it increases the pool of assets available to provide their benefits, and therefore it is logical that they should share in the potential risk of downward variation of benefits.

Context

It is important to keep in mind the context within which the sovereign annuity concept was suggested to government for consideration, and in particular the fact that we do not see this as an alternative to more fundamental reform of the pensions system.

The environment has shifted since we put the concept forward for consideration. The differential between Irish and German sovereign bonds has widened to exceptional levels, and this is likely to have consequences for trustees' investment decisions, which must have regard to both reward and risk. Other emerging factors include possible consequences for sovereign bond investors from the proposed establishment of a permanent successor to the European Financial Stability Fund after 2013.

Nevertheless, we remain of the view that the sovereign annuity concept could play a significant role in alleviating the funding difficulties currently faced by most defined benefit pension schemes, and it could alleviate exchequer funding requirements at the same time.

However, we emphasise that the sovereign annuity concept is a short-term tactical measure, and one that should be introduced only in a way that averts potential unintended consequences and market distortions. While it has the potential to have a significant impact, it is not a panacea for all the issues of pension scheme affordability, sustainability and transparency that need to be addressed. It is not a substitute for the fundamental reform of the pensions system that is urgently needed.

Enquiries on this Briefing Statement should be referred to:

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Society of Actuaries in Ireland

The Society of Actuaries in Ireland is the professional body for actuaries practising in Ireland. Actuaries provide advice and relevant solutions for financial, business and societal issues involving uncertain future events. Most of the Society's members work in the financial services industry, and the profession has a statutory role relating to the supervision of pension schemes and insurance companies. The Society seeks to make an impartial contribution to public debate on social policy and public interest matters where an actuarial perspective can add value.

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