THE SOCIETY OF ACTUARIES IN IRELAND

Position Statement on Sovereign Annuities

Legislation enabling the introduction from January 2011 of a form of "sovereign annuity" was introduced in the Dáil last week and the Minister for Social Affairs elaborated further on the concept in a subsequent briefing.

The Society of Actuaries in Ireland welcomes the new flexibility that sovereign annuities will create for trustees of defined benefit pension schemes, in particular, as they seek to come to terms with widespread funding deficits.

This initiative will provide trustees with new options that they can utilise to better manage the distribution of assets and risks between different categories of members. The extension of the proposal to include non-Irish sovereign bonds is particularly helpful in this regard. This opens up options such as the creation of "blended" annuity products and bond portfolios based on a mix of sovereign bonds. Given current sovereign bond market conditions, this is likely to lead to greater interest in the proposal in the near-term from pension scheme sponsors and trustees than might otherwise be the case.

These new options may be particularly beneficial in situations where pensioners represent a substantial proportion of total liabilities and, following falls in asset values and increases in the cost of annuities, the effect of the "pensioner priority" rule is that the level of cover for active and deferred members' benefits is low.

The initiative also provides a means to reduce the potential cost of pension obligations to the scheme sponsor, albeit by introducing some conditionality and transfer of risk, in that the security of pensions that are provided via sovereign annuities will be dependent on the security of the underlying sovereign bonds. For some schemes, the opportunity to avail of sovereign annuities to alleviate the current financial strains may avert wind-up and provide time and opportunity to transition the scheme to a more robust and sustainable structure.

However, as noted, there are risks attached to the potential reductions in pension costs and the Society would have concerns if these risks were not addressed as part of the implementation stage.

In particular, the level of risk implied by current market yields on some sovereign bonds – and, perhaps, uncertainties in relation to others - cannot be ignored.

Trustees face difficult decisions, and the appropriate response will be different for different schemes, depending on factors such as the funding level, the balance between pensioner and active/deferred member liabilities, the quality of the employer covenant, etc. Trustees and employers may have quite different objectives as regards the investment decisions.

We acknowledge that trustees will not be obliged to purchase sovereign bonds or annuities and that they will be able to combine them with traditional annuities and other fixed interest investments. However, a desire to meet the statutory minimum funding standard, as well as considerations arising from the structure of the initiative as outlined above, will create pressure to invest in high-yielding sovereign bonds or annuities.

Therefore, it will be a very helpful support to trustees and their professional advisers in availing of the initiative effectively and responsibly if, as sovereign annuities now move through the implementation stage, appropriate risk management guidance and constraints are incorporated. For example, guidance should be provided to trustees on the considerations that they should take into account when deciding whether, and, if so, to what extent, they should avail of sovereign annuities. Such guidance would help trustees to fulfil their obligation to act "honestly and reasonably"[1] in making these decisions. Furthermore, trustees should be required to provide full disclosure of the decisions in this regard, and their implications, to all members who may be affected.

Overview of sovereign annuities model

Under the model proposed, as we understand it:

- On scheme wind-up, trustees will be allowed to discharge obligations to pensioners (in whole or partially) by buying sovereign annuities;
- For the purposes of the legislative minimum funding standard, trustees will be allowed to value obligations to pensioners by reference to the cost of sovereign annuities, to the extent that they invest in sovereign bonds as a match for these liabilities;
- Trustees of ongoing schemes will be allowed to discharge the obligation to a member who reaches retirement age by purchasing a sovereign annuity in the member's name.

Comparison with the Society's proposals

The elements listed above are largely consistent with the model that the Society and IAPF proposed.

[1] *Social Welfare (Miscellaneous Provisions) No. 2) Bill 2020*

However, a key difference between the proposed structure and the ideas put forward by the Society and IAPF arises in respect of ongoing schemes. Where trustees invest in sovereign bonds (or sovereign annuities in the name of the scheme) to match pensioner liabilities, they will not have the right to vary scheme benefits if payments under the bonds (/annuities) are varied.

In certain circumstances, this may expose active and deferred members to additional risks, due to the priority of pensioner benefits. It may also create a bias (arguably unnecessary for some schemes) towards buy-out of a retiring member's benefits through sovereign annuities, or a mix of sovereign and traditional annuities, with the pensioner ceasing to be a member of the scheme. Trustees will need to consider these issues carefully, and take professional advice as necessary, when making their investment decisions.

Nevertheless, this difference does not invalidate the model which, as indicated above, will give trustees scope to better manage the distribution of assets and risks between different categories of members as they seek to address the current financial difficulties in the most equitable manner.

Conclusion

The Society welcomes Minister O'Cuív's announcement of the introduction of a new "sovereign annuity" model.

As implementation progresses, the Society is available to contribute ideas on how appropriate risk management guidance and constraints could be incorporated into the model, in order to help trustees availing of the new flexibility created to do so in an effective and responsible manner. In this regard, we welcome the Minister's commitment to further consultations on implementation.

We also welcome the Minister's declared intention to monitor developments as the market evolves.

More generally, we note the Minister's reaffirmation of his intent to expedite the introduction of a new model for defined benefit schemes early next year. We remain committed to contributing ideas on this and other fundamental reforms which we believe are needed to address the ongoing issues of pension scheme affordability, sustainability and transparency.

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Background note

In recent months, the Society of Actuaries in Ireland, jointly with the IAPF, 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 statutory minimum funding standard and for securing pensions on scheme wind-up and as members retire in ongoing schemes.

We proposed that sovereign annuities would differ from conventional annuities in that payments would be linked to the payments under Irish sovereign bonds. (The initiative now launched includes all euro-denominated sovereign bonds, a welcome extension), The reduced cost of securing pension liabilities, relative to doing so through conventional annuities based on German bonds, would mean that schemes would have more funds available to provide benefits for active and deferred members, which would mitigate the effect of the "priority rule" under which pensioners have first call on the assets in the event of scheme wind-up. Sovereign annuities would help schemes to meet their minimum funding standard obligations and would create greater equity between different categories of members than applies at present. However, we stressed that they should not be regarded as a substitute for the more fundamental reforms of the pensions system that are urgently needed.

For more details, please refer to the Briefing Statement on the Society's website at http://bit.ly/1011SovAnn.

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