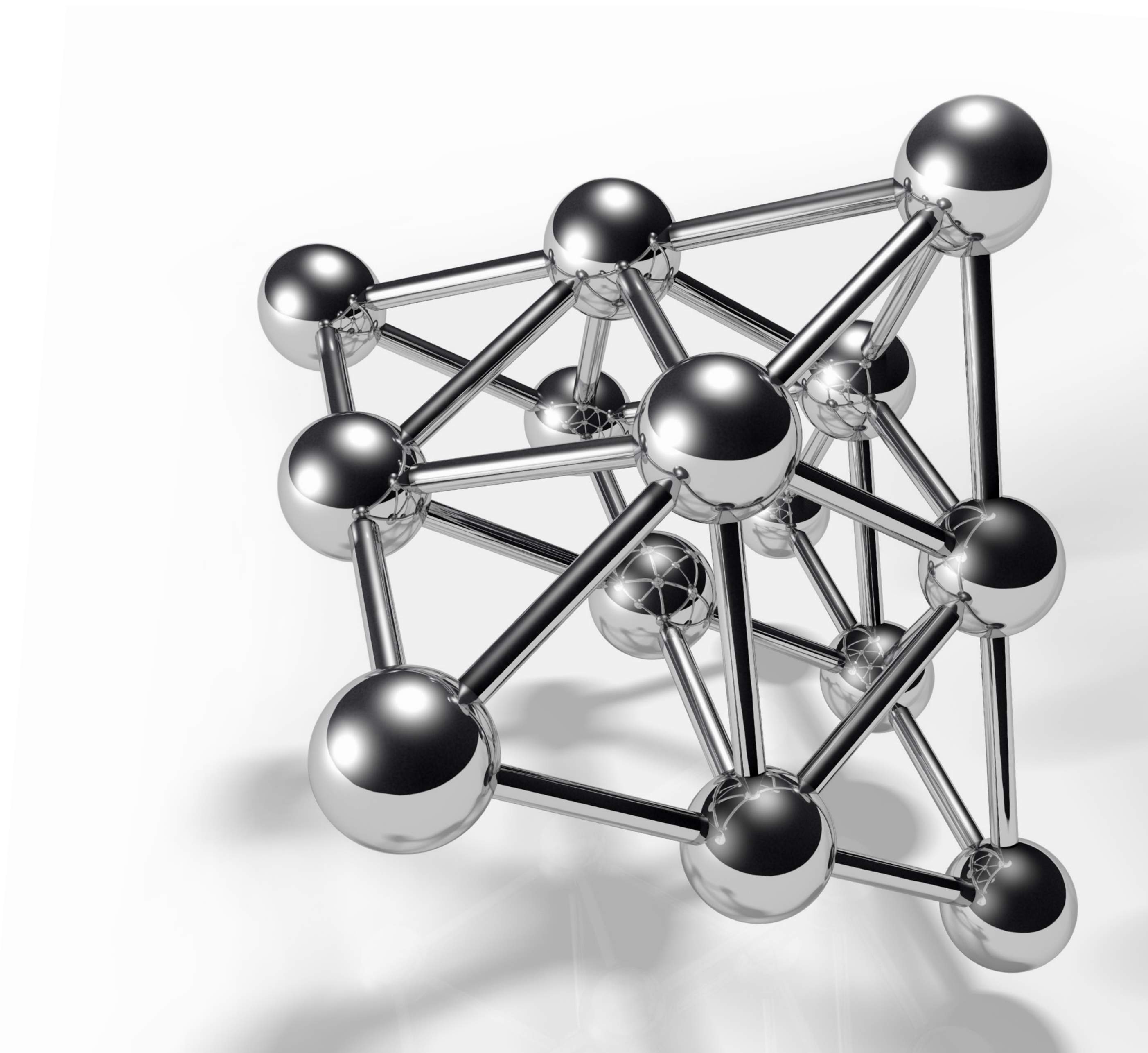
Sackers

Buy-ins, buy-outs and longevity transactions

A guide for trustees 2018



Introduction

Welcome to our 2018 guide to buy-ins, buy-outs and longevity solutions. 2017 was another big year for the bulk annuity market, with total deal volume exceeding £10bn for the fourth year running.

Sackers is proud to have played a significant part in this, having advised trustees on 15 separate bulk annuity transactions, of all sizes and structures and with all the major insurers quoting for business throughout the year. Our aggregate deal volume in 2017 reached around £2.4bn.

"As always, well prepared schemes will be the best placed to transact most efficiently and at the best prices.

Looking ahead

With many commentators suggesting that pricing is at its most attractive levels in a decade, we're expecting this year to be another important year for the bulk annuity market. There are now eight insurers actively quoting for new business and an estimated capacity of over £25bn. With the sale of Prudential's back book to deal with, insurer deal teams may, however, need to be selective in how they quote for new trustees business. As always, well prepared schemes will be the best placed to transact most efficiently and at the best prices.

But preparation shouldn't just start when a transaction is in the offing. On pages 4-5 we look at some of the steps trustees will need to take to get their scheme buy-in ready. Many of these can be started years before a buy-in or buy-out is anticipated.

For example, for a recently closed scheme with aspirations of buy-in or buy-out over the mid to long-term, there is no need to delay compiling a benefit specification. In fact, the best time to prepare one may be shortly after closure when key individuals with a detailed knowledge of the benefit structure are still around. Any issues can be resolved without the time pressure of a transaction to manage. And when a buy-in project is ready to be started, trustees will be in the best position to invite quotes from insurers based on a fully audited and accurate specification which has been properly tested against all the scheme's administrative practices. With experience of all types of scheme and transactions with every major bulk annuity insurer, we can help trustees complete this work in the most efficient way possible.

On longevity-only transactions, trustees have had to find ways to access the reinsurance market to underwrite longevity risk as UK insurers have withdrawn from the pure longevity market in the last few years. A number of potential avenues are now emerging and we expect 2018 to see more longevity-only deals. See page 8 for more information.

We hope you enjoy reading this guide. If you would like to speak to anyone about a buy-in, buy-out or longevity solution for your scheme, please contact any of the Sackers' specialists in derisking listed on page 10 or speak to your usual Sackers adviser.

Stuart O'Brien
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Transactions over £100m advised by Sackers in 2017

Name	Size	Insurer	Date	Type
Cancer Research UK	**£250m**	Canada Life	Feb 2017	Pensioner buy-in
Tullett Prebon	**£270m**	Rothesay Life	May 2017	Full buy-out
Undisclosed	**£270m**	L&G	Jun 2017	Pensioner buy-in
Post Office Limited	**£450m**	Rothesay Life	July 2017	Pensioner buy-in
Undisclosed	**£245m**	Just	Sep 2017	Pensioner buy-in
Smiths Industries	**£210m**	Canada Life	Aug 2017	Pensioner buy-in
Undisclosed	**£150m**	PIC	Dec 2017	Pensioner and deferred buy-in

Some of our key highlights of 2017

£2.4bn

We advised on deals totalling around £2.4bn

We advised on Rothesay Life's and Canada Life's biggest two deals of the year

£100m+

We advised on 15 transactions during 2017 (7 over £100m)

We advised on Just's biggest deal of the year

We advised on some of the most complicated all-risks deals yet transacted

We advised the trustees of the Blackwell's Pension Scheme on the transition of their innovative "all-risks" buy-in with PIC in 2015 to a full buy-out and wind-up of the scheme in June 2017

Preparing for a buy-in / buy-out transaction

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Give me six hours to chop down a tree and I will spend the first four sharpening the axe.

ABRAHAM LINCOLN

Clarity of objectives

Agree what you are trying to achieve before you start.

The purpose may simply be to provide an investment which closely matches a group of pensioner liabilities. In this case, trustees may have some tolerance for the buy-in not to be a precise match for the benefits insured.

At the other end of the spectrum, trustees may be looking to move quickly to a buy-out of all member liabilities. This is a far more involved process for which more time and preparation will be necessary.

For many trustees (other than experienced, independent trustees), a buy-in / buy-out is not likely to be something they are familiar with (by definition most schemes will only do one buy-out). Sufficient time should always be allowed for trustee training and engagement with the scheme sponsor to ensure all parties are aligned.

Data cleanse

The importance of ensuring that data is clean and correct will depend on the nature of the project.

It will usually be the case that the contract with the insurer will require some sort of data verification after signing, the outcome of which may require a further balancing payment. It is likely that a scheme's current GMP reconciliation status will have to be factored in. Trustees are also likely to have to give warranties as to the quality of data.

Benefit specification

The specification of member benefits to be secured is key.

Trustees should take time to agree the approach with their advisers.

For a buy-out, the trustee duty is to secure the correct member entitlements. This usually requires a full audit of the benefits administered by the scheme against the legal entitlements of members under the scheme's governing documentation.

The scheme's current trust deed and rules may not tell the full story. Some aspects may have been overridden by legislation, whilst some members may have special terms documented in contracts of employment or elsewhere on the member file.

Whilst it may be tempting to obtain quotations based on an "approximate" specification, time should always be allowed for a more thorough job.

Sackers tip
Start these two elements before a transaction

What is in / out of scope?

There may be a number of aspects that necessarily fall outside a buy-in / buy-out transaction.

AVCs or money purchase benefits usually have to be secured separately on a buy-out. And some pensioner members' benefits may have already been secured with individual annuities. These will need to be identified and excluded from the scope.

If the objective is to buy out and wind up the scheme, arrangements will need to be made to assign these into individual members' names as part of the process.

Discretions

The payment of some scheme benefits may depend on the exercise of a discretionary power by trustees.

There are three types of discretion:

- actuarial factors to be used, eg early or late payment factors, calculation of transfer values and commutation factors
- whether or not to make a payment (or as to the amount of a payment) eg a decision whether or not to pay a dependent's pension when an unmarried member dies
- to whom a benefit is to be paid.

In all cases, trustees will need to agree how scheme factors will be aligned with insurer factors.

A pre-determined approach will need to be agreed covering how the second type of discretion will be "crystallised" and mapped across into the benefit specification.

The third type of discretion will only need to be crystallised on a buy-out.

Contract requirements

The main parts of most bulk purchase annuity contracts have become fairly standardised across insurers.

However, there will be some variation and trustees should take time to identify the terms that are most important to the type of transaction they wish to achieve.

Where trustees are looking for a transaction with specialised features, such as residual or data risk cover, surrender rights, collateral or an umbrella structure, more time will need to be spent on the contract.

Consider whether key terms should be set out as part of the invitation to quote to improve negotiating leverage.

Skeletons in the closet

Depending on the level of detail in the audit of a scheme's benefit specification or data quality, there is always the possibility that issues from a scheme's history may emerge.

In a worst-case scenario, problems with a scheme's equalisation or legally imperfect benefit changes or scheme closure may be discovered.

Where these arise, not only will they need to be factored into the benefit specification used in the contract, but a member benefit correction exercise may also be required.

This is likely to add to a project timescale significantly – yet another reason why time spent on benefit specifications long before a buy-in / buy-out project is commenced will rarely be wasted.

Jargon buster

This section gives a no-nonsense practical explanation of all the key terms that you should be familiar with if you are contemplating a buy-in / buy-out transaction this year.

All-risks / data risk

"All-risks" does not mean all risks. Insurers will, for an additional premium, agree to extend the scope of a buy-in / buy-out policy to cover some additional risks, for example, errors in the membership data. There will always be some risks which the insurer does not accept. Some insurers refer to the additional coverage as "data risk" or "residual risk" cover, which is probably more accurate.

"Buy-in vs buy-out"

A buy-in is a scheme investment: an insurance policy issued by an insurer to the trustees. At buy-out, the insurer writes individual policies in each member's name, at which point the buy-in terminates. Before buy-out, the trustees will often continue to administer the members' benefits, meeting payments from the income stream from the insurer. At buy-out, the trustees step out of the way leaving the member to deal directly with the insurer.

Collateral

In any buy-in, the trustees accept the risk that the insurer will not be able to meet its obligations under the contract. This is why many trustees take expert advice on the insurer's financial status and the implications of the insurance regime within which the insurer operates. For very large transactions, the trustees may be able to negotiate collateral arrangements whereby the insurer's obligations are backed up by a pool of assets which would become available to the trustees directly in certain circumstances, such as the insurer's collapse.

Data cleanse and "true-up"

A buy-in policy is not a policy insuring your scheme's benefits; it is a policy of insurance covering the member data and benefit specification you agree with the insurer. Hopefully the two will match. After the buy-in policy is in place, there will be a period (typically 12 months) during which the insurer and administrator will verify the scheme's data and benefit specification to iron out any errors. There may be pricing implications with further premium to be paid for any true-up, so preparing a high-quality benefit specification and checking data in advance is a fundamental part of the buy-in process (see "Material adjustment" below).

Material adjustment

If errors are identified during the data cleanse phase of a buy-in, the policy will be repriced. Typically, if the impact of the data cleanse is small (say 5% above or below the quoted price for the policy), the insurer will agree to apply the same pricing methodology they applied when they quoted for the policy. If the impact of the cleanse falls outside the pre-agreed parameters, the contract will typically include a "material adjustment" or "MAC" mechanism, whereby the insurer can re-price on the basis of the prevailing methodology at that time.

Medical underwriting

Insurers can use medical and lifestyle information on a scheme's membership to refine their assumptions about how long members are likely to live and draw their pensions. Without this information, insurers are relying on inference from factors like the member's age, their postcode and the size of their pension. The hope is that better data will result in keener pricing; but trustees will want to understand how the insurer goes about gathering the information and how this will improve the premium paid.

Phasing

This usually refers to the identification of "tranches" of scheme members whose pension benefits can be secured to optimise pricing and opportunity. Among other things, the tranches could identify pensions in payment with current deferred members to be added in batches when they have themselves become pensioners. Alternatively, different benefit structures within a scheme might be prioritised or the most significant liabilities secured first.

Solvency II

Insurers need to make appropriate reserves to back up the liabilities they accept. Solvency II refers to the European legislation which came into effect on 1 January 2016 containing harmonised rules around insurer capital reserving. The market has already factored in the impact of these rules in terms of pricing, but Solvency II rules can also impact what insurers will agree to in terms of a policy's optionality.

Top-slicing

Top-slicing is usually used in conjunction with medical underwriting. Top-slicing means identifying and insuring the members with the biggest pensions. Because the insurer can focus on a relatively small group of individuals relative to liabilities, they should in theory be able make a more accurate longevity assumption and therefore offer a more competitive price. Trustees need to think about treating all members fairly in choosing to insure a particular section of the membership.

Umbrella contracts

Trustees sometimes want to insure sections of their membership in tranches, rather than insuring all members in one go. An umbrella contract acts as a framework. The parties lock-in a set of legal terms and transact on those terms for each tranche of members when the pricing is right. The hope is that this will minimise the need for renegotiation of legal terms each time the parties want to deal, allowing parties to transact faster and to take advantage of short-term pricing opportunities. Of course, locking in the umbrella does not mean that the insurer has to deal with you in the future, nor does it guarantee the price!

Longevity transactions: key challenges

Longevity insurance continues to be an important option in the pension scheme derisking toolbox, especially for schemes which have already fully hedged their interest and inflation risk. However, the transaction structure and the commercial drivers behind longevity deals require greater focus on getting the contractual terms and the legal set-up right.

Buy-ins and longevity: distinguishing features

In many respects, buy-in contracts and longevity insurance contracts are very similar. But there are some key differences:

- longevity insurance contracts tend to be collateralised
- the benefits covered by longevity insurance are often based on a more simplified benefits specification
- trustees retain the investment risk in longevity insurance contracts.

The importance of reinsurers

Transaction structures for longevity insurance are evolving in response to a fundamental structural shift in the longevity insurance market. For the time being, UK-based insurers have stopped offering pure longevity insurance. They do, of course, still offer longevity insurance as part of a buy-in contract but, currently, pure longevity hedging for UK pension schemes is only offered by the global reinsurance market.

Trustees looking to hedge their longevity risk therefore need to find ways to access the reinsurance market. There are a number of potential routes available to achieve this:

- via trustees / sponsor-owned captive insurer
- an insurance cell set up and maintained by one of the investment consultants
- a commercial UK insurer-offered pass-through structure, where a third-party UK insurer intermediates between the trustees and the reinsurer, but without absorbing the default risk of the reinsurer.

The common feature of all of these transaction structures is that trustees have to understand and manage the credit risk of the reinsurer. In practical terms, this credit risk can be mitigated via collateral. However, unlike buy-in / buy-out contracts which take place within an exclusively English law context, the presence of international reinsurers requires a more detailed legal analysis. It is crucial to ensure that the collateral structure and reinsurance agreement can be enforced against the reinsurer in the event of its insolvency under the laws of the jurisdiction in which the reinsurer is based.

Endgame: buy-in / buy-out

For many trustees, a longevity hedge is one step in the broader derisking journey towards a buy-in or buy-out. If this is the case, the longevity hedge will need to be novated at the point of buy-in / buy-out to the relevant insurer and this will need to be reflected in selecting the most appropriate transaction structure. It will also inform the negotiation of the contractual provisions as well as the subsequent administration of the transaction.

What our clients say

Tullett Prebon secured the members of the TP ICAP's pension scheme through a £270m bulk annuity with Rothesay Life

> **The Trustees' first priority has been to ensure the future security of members' benefits. With pricing being better than early estimates, all parties worked to agree the final price and terms over a short time, resulting in a secure outcome for the members of the Scheme. Sackers were instrumental in guiding the trustees through this complex transaction in a demanding timescale.**

CLIVE GILCHRIST, CHAIRMAN OF TRUSTEES

Blackwell's completed "all risks" buy-out of its defined benefit pension scheme with Pension Insurance Corporation

> **The buy-out and wind-up of the pension scheme was great news for the members as it secured their pension incomes in full, but it was also a major milestone for Blackwell's, removing the risk from its balance sheet and enabling it to move towards its long-term goal to become an employee partnership. Sackers' advice was invaluable in getting the Scheme through the transaction and ironing out issues that might typically arise in any scheme with over 60 years' history.**

CLAIRE ALTMAN, FORMER CHAIRMAN OF TRUSTEES

Smiths Industries completed £210m buy-in with Canada Life

> **The Trustees completed two bulk annuity purchases in October 2016 and August 2017 as part of their strategy to reduce risk in the Scheme. As a departure from the more typical investment management agreements, there was less familiarity on the trustee board with the form of the documentation and, given time-limited nature of annuity quotations, it was important to have a legal adviser capable of assessing and talking trustees through the contractual terms in a relatively short timeframe whilst giving a firm sign off to the various documents. On both occasions, Sackers fully met the requirements and expectations on the legal side of the purchases, leading to the successful completion of both deals.**

MIKE ABRAMS, DIRECTOR UK PENSIONS

Contact

Sackers is the UK's leading commercial law firm for pension scheme trustees and employers. Over fifty lawyers focus on pensions and its related areas, including Sackers' finance and investment group. Our specialist team of lawyers provide cutting edge advice on buy-ins, buy-outs and longevity transactions.

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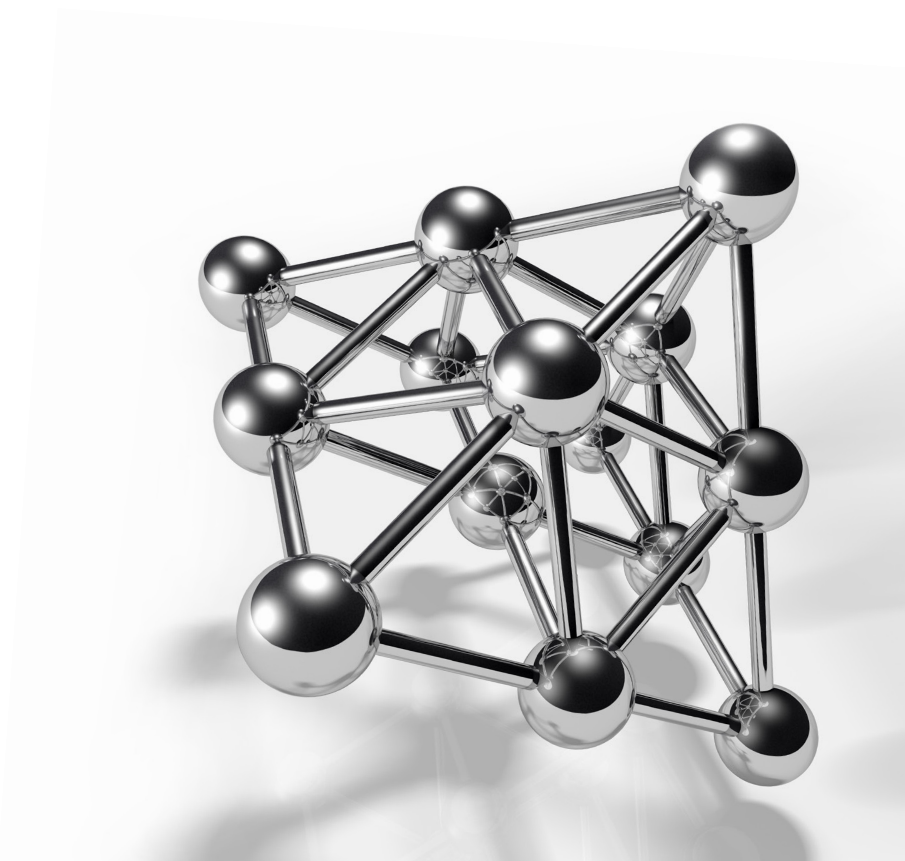

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