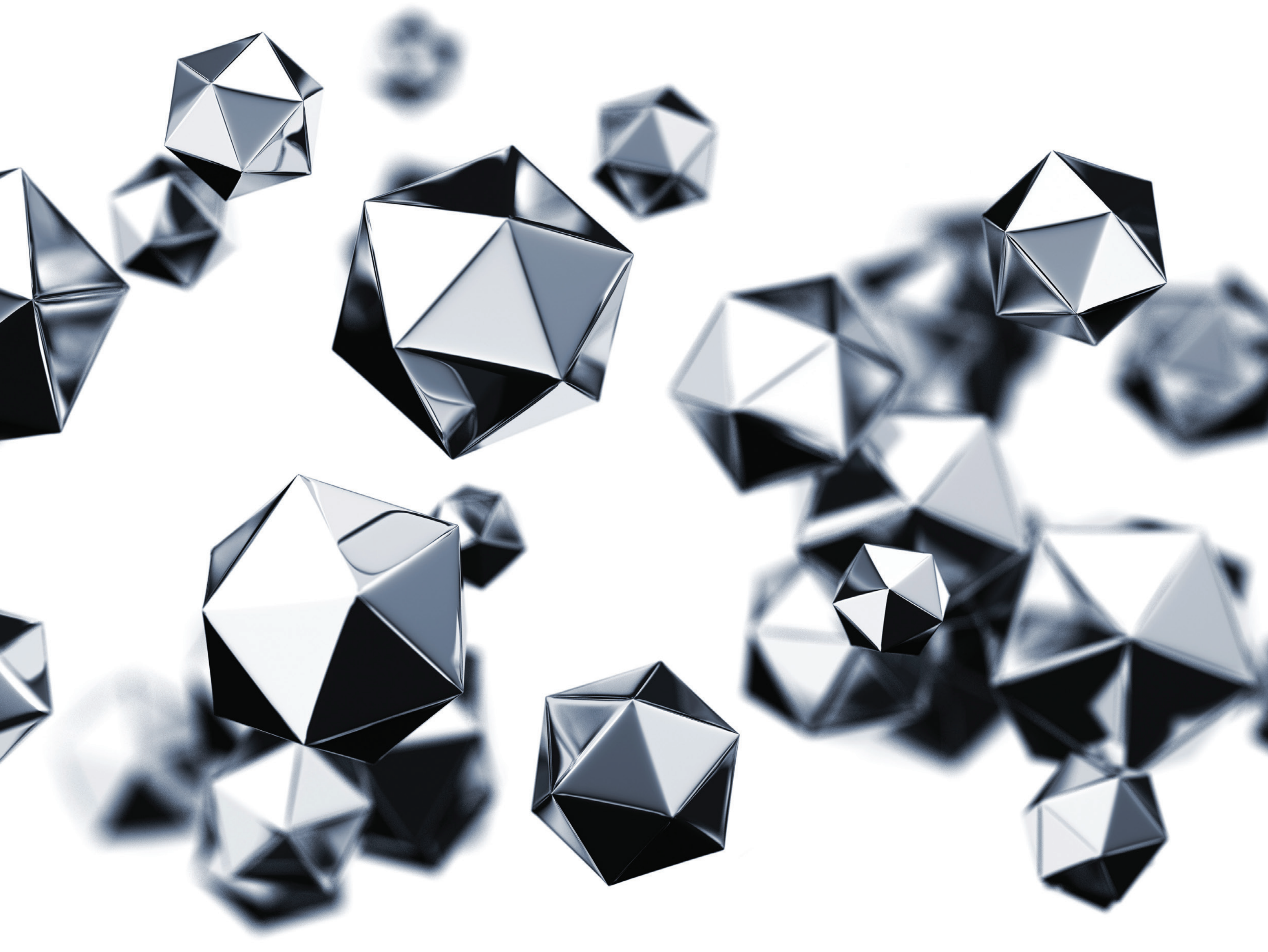
Buy-ins, buy-outs and longevity transactions

A guide for trustees 2019



Introduction

“

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

Welcome to our 2019 guide to buy-ins, buy-outs and longevity solutions. The bulk annuity market continues to be very active and Sackers is proud to play a significant role in this. In 2018, we advised on 16 separate bulk annuity transactions, of all sizes and structures. Over the last two years, we have worked with all the major insurers quoting for business. Our aggregate deal volume for buy-ins and buy-outs during 2018 was in excess of £3.5bn. We also advised on a multi-billion pound longevity swap (structured through captive insurers).

Many commentators are predicting high volumes of business again in 2019. Our advice to schemes with aspirations to buy in or buy out over the short to medium term is that it is never too soon to start preparing. Those schemes which are transaction-ready will be better placed to achieve an optimal outcome when approaching insurers. On pages 4-5 of this guide we explain some of the preparatory steps which trustees can take. We also highlight, on pages 6-7, some knotty issues which are likely to come up during the negotiation process.

With our experience of all types of schemes and transactions with every major bulk annuity insurer, we can help trustees ensure they are in the best possible position to transact.

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 de-risking listed on page 11 or speak to your usual Sackers adviser.

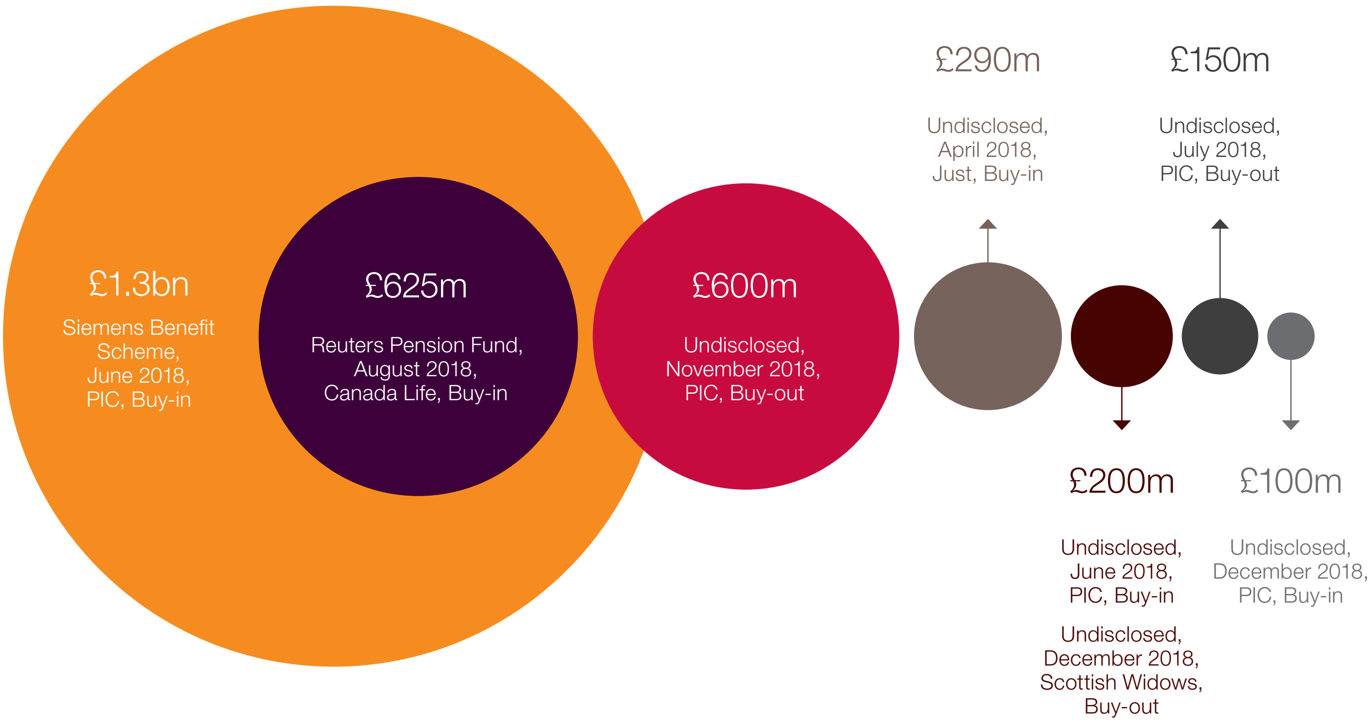
Ian Cormican
Partner
ian.cormican@sackers.com

Contents

Facts & figures

Transactions over £100m on which Sackers advised in 2018

Listed in order of size, client, date, insurer and transaction type



Some of our key highlights of 2018

£3.5bn+

We advised on deals totalling more than £3.5bn

We advised on deals representing more than 17.5% of the market

We advised on several buy-ins converting to full buy-outs

£100m+

We advised on 16 transactions during 2018 (8 over £100m)

We advised on a range of buy-ins, all-risks deals and umbrella contracts

We advised the trustees of the Siemens Benefit Scheme on a full buy-in covering £1.3bn of liabilities and 6,000 members

We advised the trustees of the Reuters Pension Fund on a £625m full pensioner buy-in with Canada Life, the insurer's largest ever deal

Preparing for a buy-in / buy-out transaction

"

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 Guaranteed Minimum Pension (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.

Additional Voluntary Contribution (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 individual annuities 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 relevant here:

- 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 dependant'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.

Knotty issues

There are many issues that can derail a successful buy-in or buy-out project but often it is the small points that are overlooked which can cause the most frustration or delay. On these pages, we highlight a few of the points that trustees may wish to consider sooner rather than later in a project to avoid any nasty surprises.

1

Aligning administration processes

One of the key requirements to any successful buy-in is that there is an accurate match between the benefits payable by the scheme and the benefits payable to the scheme from the insurer. Accurate data and benefit specifications are a pre-requisite but trustees should also focus on ensuring that administrative processes are well aligned too. This includes:

- Commutation factors – it is important that, where members have rights to benefits that are commuted for cash, the factors used by the scheme are aligned with those used by the insurer. This is usually more of an issue for buy-ins involving deferred members than for pensioner-only buy-ins, where fewer commutation options arise
- Existence checking – pensions in payment will cease on a member's death. Having a robust existence checking process is a basic requirement of any scheme but insurers may operate more stringent checks than a scheme is used to. It is a good idea to get an early understanding of the selected insurer's requirements before entering into a transaction, so that the scheme can be sure of adopting the required processes from day one following the buy-in.

2

Member options

It may not be possible to retain all options afforded to members following a buy-in. Advice should be taken based on the benefit design of the scheme but the following member options are likely to need to be reviewed:

- Transfer options – insurer terms will often limit the payment of transfer values to a member's statutory rights (ie more than one year from normal retirement date). If a scheme has a practice of paying transfer values at any point up to a member's retirement, this may need to be reviewed
- PIE options – some schemes allow members to exchange the pension increases usually provided on their pension in return for a higher flat-rate pension. Insurers may not be able to offer this as a long-term option
- Surrender of pension for a higher dependant's pension – although rarely exercised in practice, some scheme rules contain rights for members to give up part of their own pension on retirement in return for a higher dependant's pension. However, this is not typically an option provided by most insurers.

3

GMPs

At present GMP reconciliation and GMP equalisation processes are unlikely to have been completed, but will be on the "to do list" for most schemes. Insurers will typically allow a period of 12 months after a buy-in has been signed for a data cleanse process to be completed. Trustees would be wise to consider in advance what approach they will take to GMP reconciliation and equalisation during that period. For a buy-out, an insurer may have a required approach for GMP equalisation (typically, this may involve conversion of the GMP into a non-GMP benefit using a statutory process). Trustees should consider the feasibility of achieving this in the data cleanse period or whether more time might be required.

4 AVCs

It is common for schemes providing money purchase AVCs to offer members the option to use those AVCs at retirement to fund the member's pension commencement lump sum. This can be a more attractive option for a member than commuting their defined benefits. Typically, a buy-out will involve the transfer of the defined benefits to the insurer but not any defined contribution AVCs (although some insurers offer a limited AVC facility). Where a transaction involves the necessary loss of any AVC commutation option, it will be important that this is clearly communicated to the members in advance.

5 General Data Protection Regulation (GDPR)

Changes in data protection legislation are unlikely to have escaped the notice of many trustees over the last few years. However, it is important in a buy-in to also recognise the insurer's status under the GDPR. In nearly all cases, an insurer will be a data controller in respect of member data provided to it.

Trustees will need to consider how this should be reflected in the buy-in policy terms, but should also be aware that the insurer will almost certainly need to provide some communications to the scheme's members under the legislation. As a data controller, there will be a requirement for the insurer's own privacy notice to be made available to scheme members whose benefits are insured under the transaction.

Different insurers will have different requirements but trustees should generally expect (and have planned in advance) for their own privacy notice to be updated as soon as possible following the signing of the buy-in. Trustees should also discuss with the insurer (in advance) what arrangements will need to be made to provide copies of the insurer's privacy notice to those members.

6 Tax protections

Legislation generally provides for member tax protections to be maintained on a bulk transfer of liabilities from one pension scheme to another. The transfer of member benefits to an insurer on a buy-out is similarly protected. However, there are some unfortunate gaps in the legislation, the effect of which is that that some tax protections might technically be capable of being lost on a buy-out. It is generally believed that such gaps are inadvertent and will be corrected by subsequent legislation but advice should be taken, and it would be sensible to identify members with tax protections in advance where possible.

7 Financial Services Compensation Scheme (FSCS)

Generally speaking, annuity contracts (which include buy-ins held by trustees and buy-out policies in member names) will be covered by the FSCS. However, the FSCS does not provide universal cover. Under its rules it requires an "eligible claimant" to have an "eligible claim". Following a buy-out it is possible that some members may not be covered, particularly if they live overseas. Trustees may wish to consider this and take advice as part of their general consideration of a transaction.

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:

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

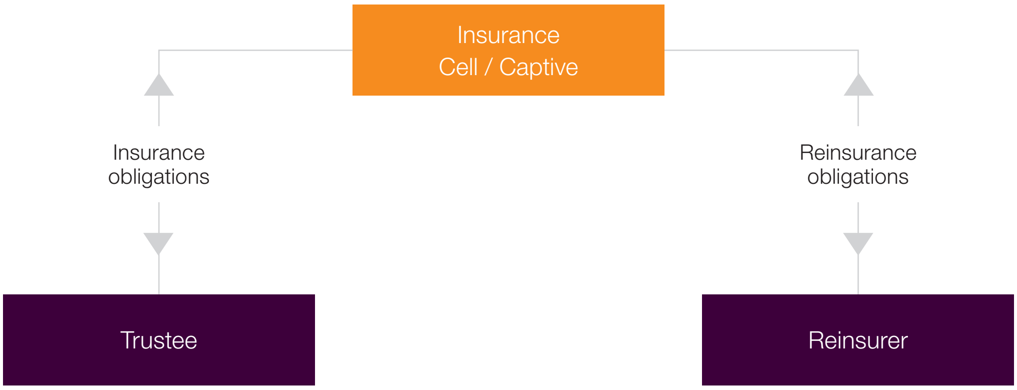
The importance of reinsurers

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 may need to be novated at the point of buy-in / buy-out to the relevant insurer. Otherwise, it may be that part of the longevity hedge must be terminated to accommodate the buy-in or buy-out, while the remainder of the hedge continues. These options will need to be reflected in selecting the most appropriate transaction structure and in the negotiation and drafting of contracts. For some, this may require flexibility through an "agreement to agree" mechanism, where for others it may be more important to have a concrete right to novation, with conditions to be met set out in the agreement.

Sackers has significant experience with a variety of transaction structures, and has negotiated positions on novation and partial termination with a number of reinsurers. We are keen to help navigate this tricky area and to ensure that the longevity hedge does not become an impediment to fulfilling a scheme's journey down the line.

What our clients say

£625m

Reuters Pension Fund completed a £625m full pensioner buy-in with Canada Life

Working with Sackers as our legal advisers, our actuary (Aon) and investment manager (Redington), the trustees devised a progressive buy-in strategy for the Reuters Pension Fund which culminated in the successful execution of a £625m buy-in with Canada Life in August 2018, securing those liabilities and removing their risk from the scheme. I'd have no hesitation recommending our team to other trustees. Sackers did a great job working with the many parties involved; as well as excellent preparation of our negotiating position, their work in the final hiatus before contract signing was an essential contribution to the successful outcome.

GREG MEEKINGS, CHAIR OF TRUSTEES,
REUTERS PENSION FUND

£1.3bn

Siemens Benefit Scheme secured the benefits of around 6,000 members in its DB scheme through a £1.3bn buy-in with Pension Insurance Corporation

We have the highest regard for the help Sackers gave us during our project. They worked collaboratively with our other advisers and drew on their extensive knowledge of the buy-in market to provide us with high quality advice within the tight timescales required to complete our transaction.

JOANNA MATTHEWS, CHAIR OF TRUSTEES,
SIEMENS BENEFITS SCHEME
ROBERT BENNETT, SENIOR MANAGER,
PENSIONS INVESTMENTS, SIEMENS BENEFITS SCHEME

Contact

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

Paul Phillips, Partner
D 020 7615 9523
E paul.phillips@sackers.com

Ian Cormican, Partner
D 020 7615 9501
E ian.cormican@sackers.com

Stuart O'Brien, Partner
D 020 7615 9539
E stuart.obrien@sackers.com

Ralph McClelland, Partner
D 020 7615 9532
E ralph.mcclelland@sackers.com

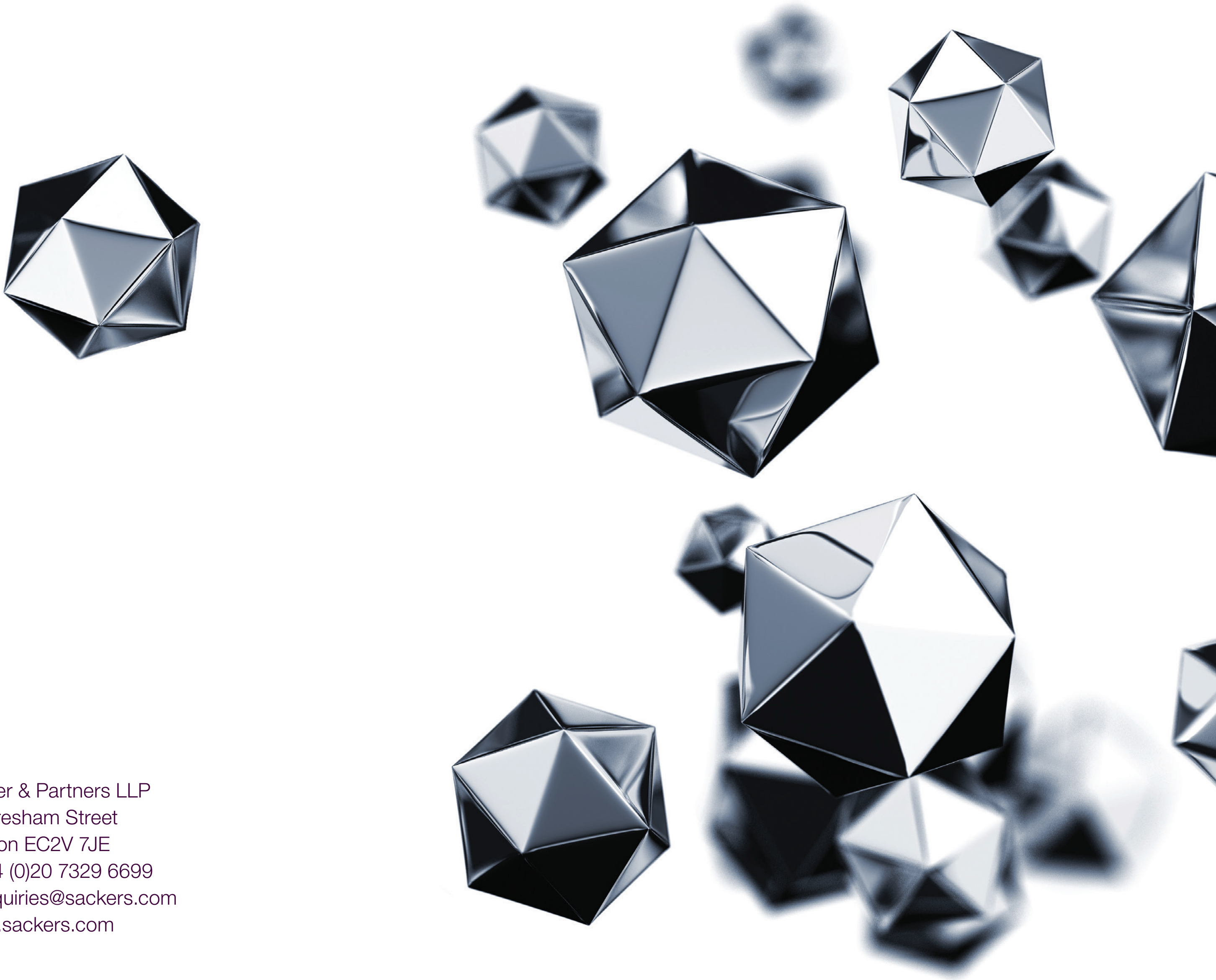
Tom Jackman, Associate Director
D 020 7615 9548
E tom.jackman@sackers.com

Naomi Brown, Associate Director
D 020 7615 9513
E naomi.brown@sackers.com

Sarah Henderson, Senior Associate
D 020 7615 9030
E sarah.henderson@sackers.com

Mike Fallow, Associate
D 020 7615 9503
E mike.fallow@sackers.com

Sackers



Sacker & Partners LLP
20 Gresham Street
London EC2V 7JE
T +44 (0)20 7329 6699
E enquiries@sackers.com
www.sackers.com