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Residual risk and trustee protections

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The risk transfer market has showed itself to be remarkedly resilient in recent years. Bulk annuity transactions are booming, and annuity providers continue to have an excess of business. This increasingly mature market is continuing to evolve and adapt, particularly in the field of “residual risks” (those risks associated with a scheme that are not secured with a bulk annuity provider).

How do residual risks arise?

While a bulk annuity contract (whether a buy-in or buy-out) is intended to track closely the benefits of the scheme being secured, in practice the insurer will only take on the liabilities as a body of administrative data, interpreted by a short benefit specification. The insurer does not agree to administer the benefit in accordance with the scheme’s original documentation (as the trustees are required to do). After buy-in, the insurer will usually not check the trust deed and rules, refer to the original administrative record or look back at other original scheme documentation. Consequently, in a standard transaction some risks are simply not passed on the insurer and therefore potentially remain with the trustees.

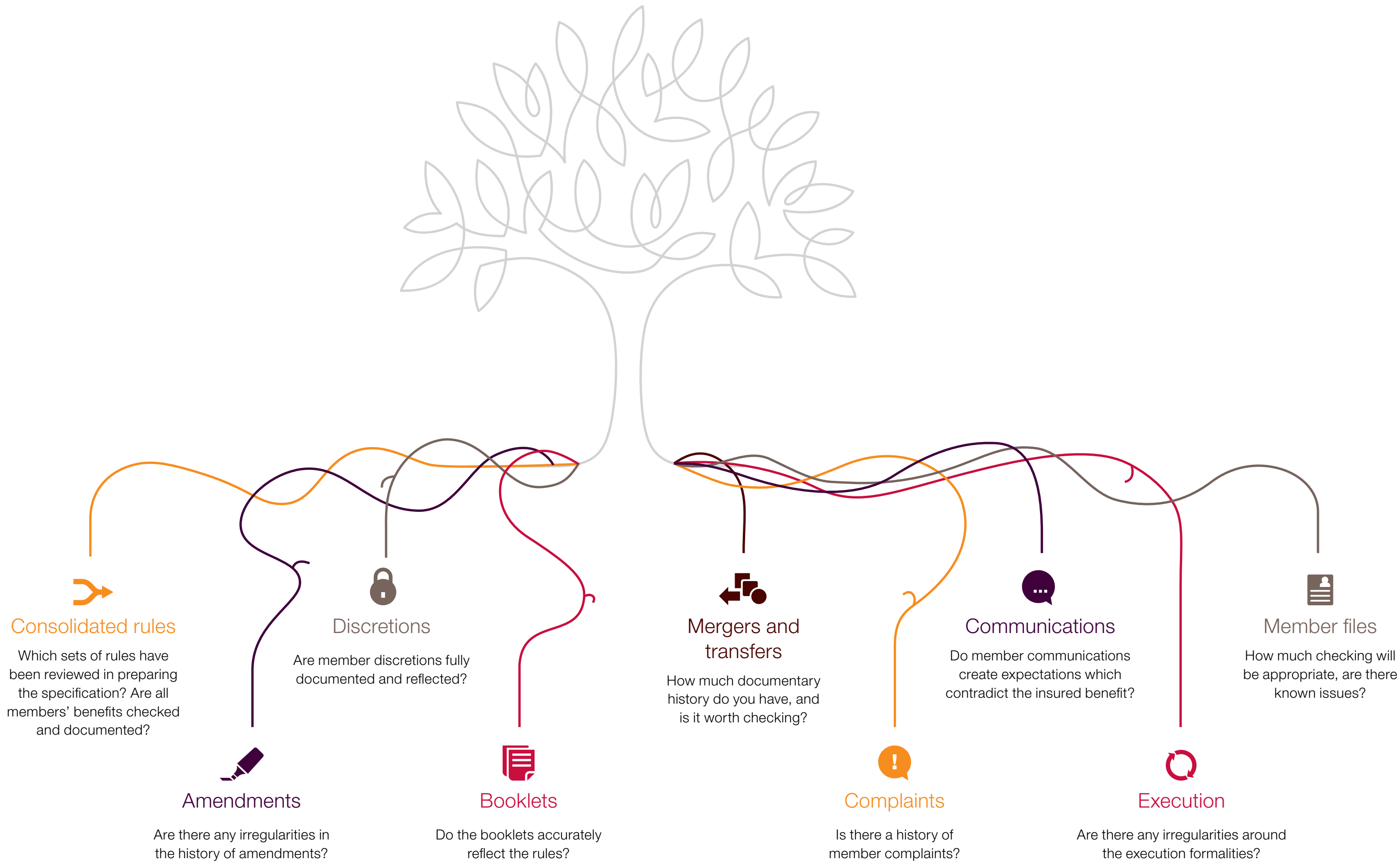
Examples of those risks which might not pass include:

- data errors: the data supplied to the insurer showing a deferred members’ final salary is accurate
- benefit errors: the benefit specification in the bulk annuity has incorrectly recorded some members’ pensions increase rate
- member claims: a member has a letter or booklet which seems to show they are entitled to a different benefit to the one secured
- missing beneficiaries: a member can show they were entitled to a pension from the scheme, but have not been included in the bulk purchase annuity.

How significant are residual risks?

Given the age of some UK schemes and the history in which they are rooted, residual risks are worth considering before embarking on a buy-in or buy-out project. A scheme’s data record may be old and may have passed through the hands of multiple administrators. The lifespan of a scheme may involve complexity, including multiple consolidated rules, amendments and legislative change. There may be merged-in sections where the records and institutional memory have been lost to a greater or lesser extent.

When one considers the volume of historic deeds, booklets, member files, communications, any complaints etc which are often associated with older schemes, this should give pause for thought. This wealth of documentation and history has potentially significant implications for the confidence trustees may have in the accuracy of the benefit they have asked the insurer to cover.



Preparation

Careful preparation will mitigate these risks.

A decision to buy in or buy out is ordinarily part of a scheme's end-game planning and is therefore a sensible point in the scheme's life cycle to consider any issues around data accuracy or any lingering questions about the scheme's documentary history.

Some schemes will have the benefit of a simple, uniform benefit structure, an uncluttered history of amendments and clean data. Indeed, a well-run scheme, having gone through a sensible process in preparing its data, may have a high degree of confidence that it has minimised residual risks and achieved high levels of accuracy in its data and benefit specification.

Trustees should speak to their advisers and their administrative teams about how best to prepare for buy-in or buy-out transactions in the context of their scheme history. It may be time to look again at any skeletons in the closet, but this is not a simple decision, and there are undeniably downsides to embarking on an extensive documentary review, which might ultimately result in expense and delay without an obvious upside for members.

Residual risks cover

Additional cover for some of the residual risks might also be available from the bulk annuity provider (so called “data”, “residual” or sometimes “all” risks cover), however at the moment not all providers offer this, and typically only for larger transactions, and there will always be exceptions and carve out to the scope of cover.

This form of residual risks cover has the benefit of potentially transferring responsibility for data and benefit accuracy to the bulk annuity provider to the extent that this cover can be secured. It can also offer a more natural way to tackle any emerging issues from the member perspective: the insurer is the obvious recipient of any queries once they have taken on administration after buy-out.

In practice, residual risks cover will also involve a greatly enhanced due diligence exercise which might include data audits, testing benefit calculations and administration processes, and review against scheme documents. This exercise is significant for the scheme advisers and administrators, so trustees should carefully consider the appetite for residual risks cover.

This needs careful thought, not least in terms of timing and a full understanding of the limits of any cover that may be achievable. In any event, annuity policy residual risks cover is never comprehensive and trustees also need to consider what other protections they can put in place.

Trustee protections – what happens at the endgame?

Where trustees have negotiated residual risks cover from their bulk annuity provider, the question may arise as to whether a particular member complaint would be covered. All complaints will depend on their particular circumstances but there is no doubt that there will be some types of complaint that will not be caught (typically through exclusions built into the cover). It should also be noted that a typical residual risk policy would not usually provide cover for trustees’ own legal costs and expenses as bulk annuity policies cover member benefits, not the costs and expenses of the trustees.

Other options available for trustees:

- Company indemnity

  Trustees in the process of buying out should seek to make a broad company indemnity a pre-condition. The indemnity should be from a substantial company, uncapped and of unlimited duration. Of course, an indemnity is only as good as the company offering it, and not all trustees have the luxury of this option. It is also a moving picture and it is very difficult to address the risk of a company’s changing circumstances. Will the indemnity be as solid in five years’ time as it is today?

- Run-off cover

  Trustees may also seek run-off cover from a third-party general insurer. This is an additional and different insurance policy to the bulk annuity contract. The buy-out policy will be in members’ names whereas the run-off policy will be for the benefit of trustees specifically.

  Whereas previously run-off cover was a fairly standard and predictable product, in recent years the market has been in a state of flux and such policies are currently harder to obtain, more expensive and on more restrictive terms.

Left-over risks in perspective

It is important to keep the scope of these left-over risks in perspective. Schemes that buy out are typically mature and will have had many pensions in payment over decades. For a well-run scheme, the reality is that any likely claims should have been flushed out. Pensioners tend to focus on the value of their benefit most acutely when they first came into payment, and the passage of time tends to diminish the likelihood of a claim.

Similarly, the process of buying in, and then buying out, usually involves extensive checks on the scheme data and, to some extent, the documentation. Schemes can mitigate their risk by focusing on this checking process, particularly in terms of the legal documentation which is often a secondary focus compared to the data.

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