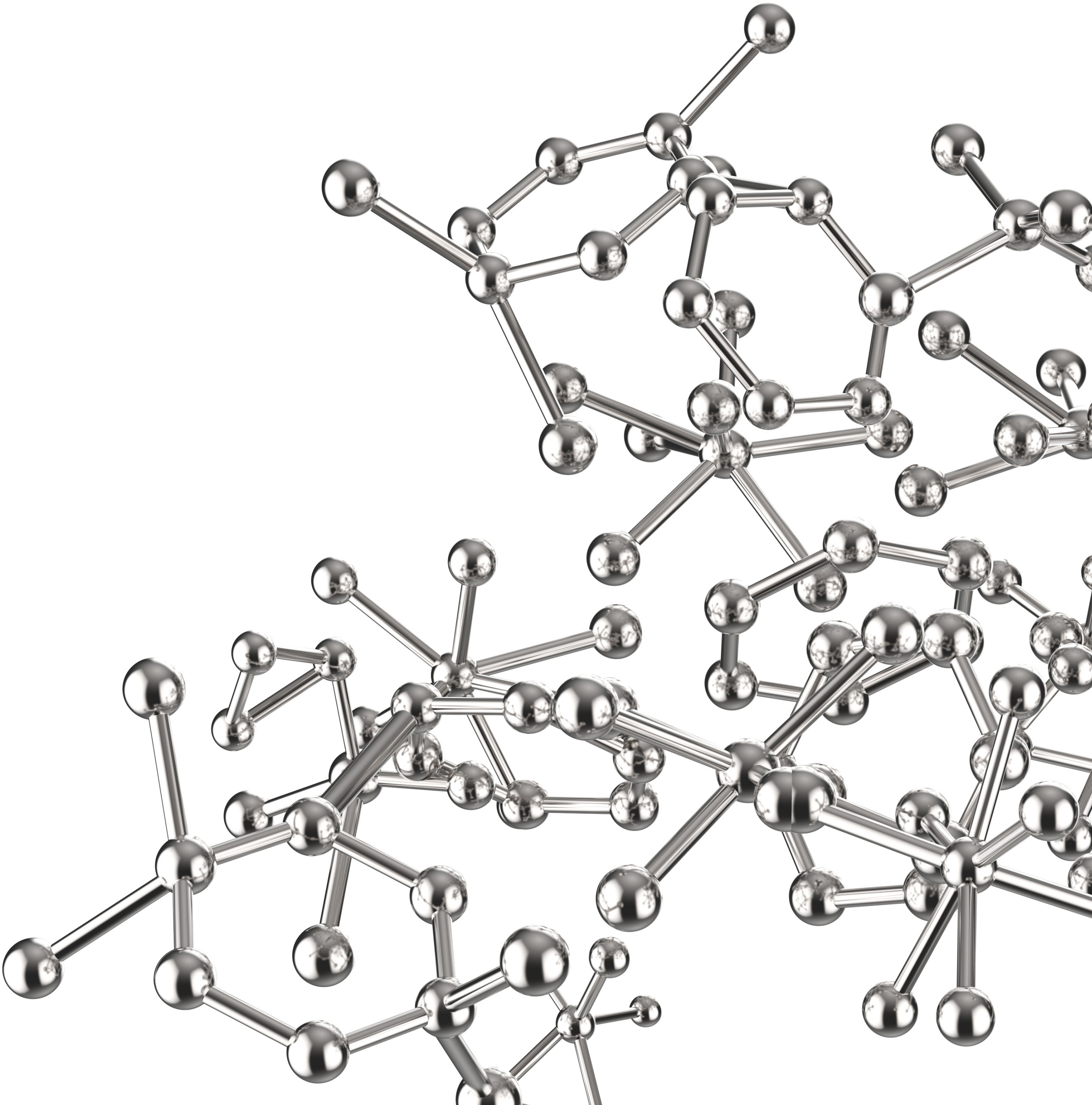
Sackers

Buy-ins, buy-outs and longevity solutions

A guide for trustees 2020



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For more information on our CSR policy, please visit our website at www.sackers.com/about/csr

Introduction

Welcome to our 2020 guide to buy-ins, buy-outs and longevity solutions. 2019 was another record-breaking year for the industry and we are delighted to have advised on some of the most significant transactions. These included 13 separate bulk annuity transactions, with an aggregate deal value of £12.6 billion and representing a quarter of the market in 2019. We also advised on the third biggest longevity swap ever transacted in the UK, for the trustees of the HSBC Bank (UK) Pension Scheme.

The market is set for another bumper year and, even for relatively large transactions, schemes will need to present themselves well to be a priority for insurers with full pipelines of business. Our advice remains that good preparation can make all the difference. On page 5 of this guide we explain some of the preparatory steps which trustees can take. We also highlight, on pages 6 and 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 derisking listed on page 11, or speak to your usual Sackers adviser.

Ralph McClelland
Partner
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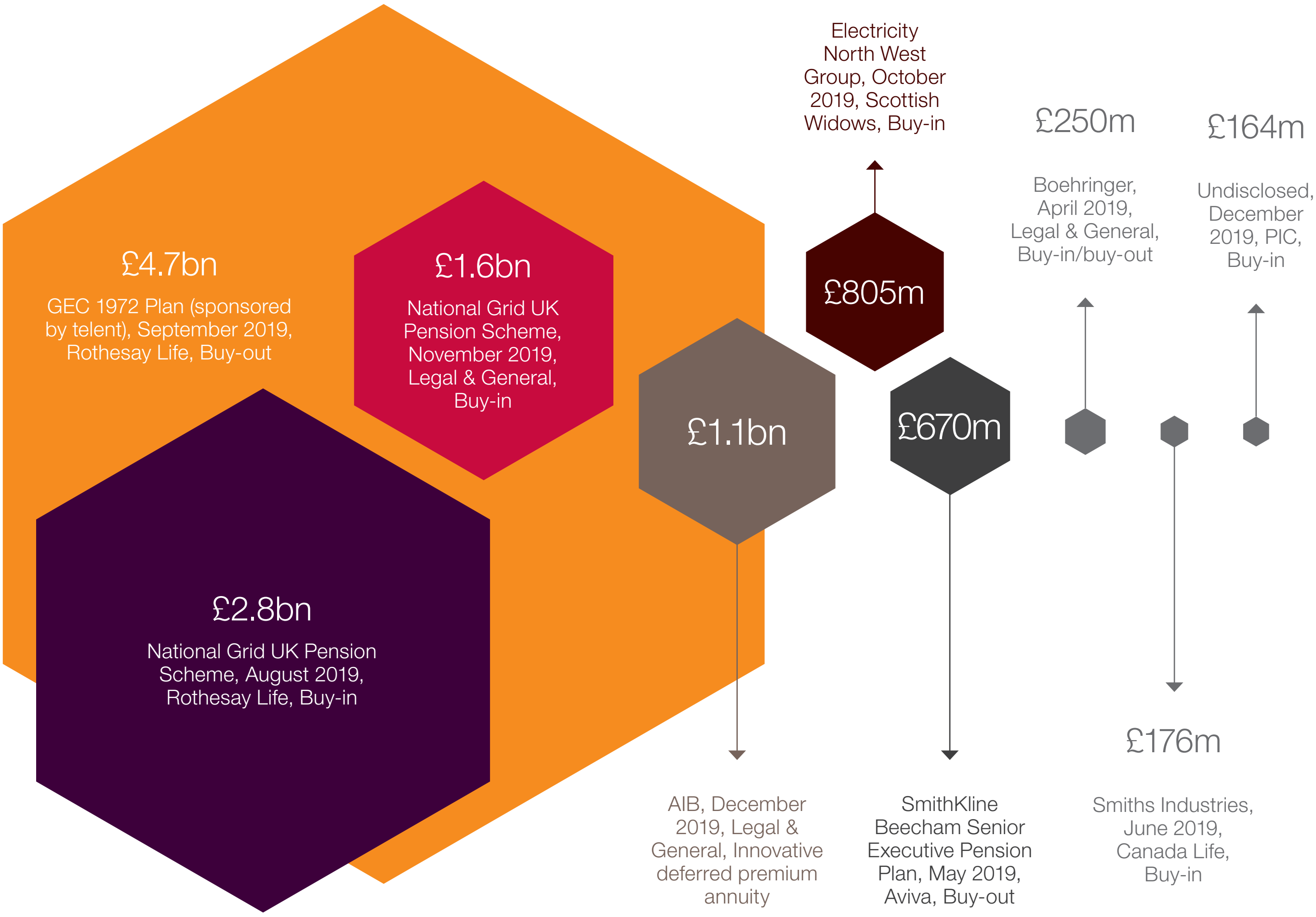
For more information about transactions on which we advised in 2017 and 2018, download our previous guides from our website.

Facts & figures

Transactions over £100m on which Sackers advised in 2019

Listed by size, client, date, insurer and transaction type



Some of our key highlights of 2019

£12.6bn+

We advised on bulk annuity transactions representing more than a quarter of the anticipated market value of around £40bn for 2019

We advised the Trustees of the National Grid UK Pension Scheme on two buy-ins, relating to Section A and B of the scheme, with Rothesay Life and Legal & General respectively, totalling £4.4bn. The National Grid UK Pension Scheme was the largest scheme to use buy-ins to manage risk in 2019

£7bn

We advised the Trustees of the HSBC (UK) Pension Scheme on their £7bn longevity swap with PICA, the first to be intermediated through a Bermuda captive insurer

We advised the Trustees of GEC 1972 Plan (sponsored by telent) on a £4.7bn buy-out with Rothesay Life, the largest full scheme buy-out ever undertaken in the UK

£1bn+

We advised on 13 bulk annuity transactions, 4 over £1bn

Preparing for a buy-in / buy-out transaction

Clarity of objective

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 be willing 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.

Care and planning are always needed for AVCs and legacy annuity policies, as insurers may be unwilling to take these on.

Data cleanse

Having good quality membership data should be a priority, and there's no reason to wait.

A scheme with more accurate data will have less scope for price adjustment during the data cleansing process and therefore greater certainty on pricing.

Benefit specification and discretions

The specification of member benefits to be secured is key.

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

Trustee discretions will often need to be considered and simplified ("crystallised") so that the insurer can administer the benefit. Again, this needs time and legal input.

Contract requirements

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

Where trustees are looking for a transaction with specialised features (such as residual or data risk cover, surrender rights, collateral or an umbrella structure) this should be raised at the outset.

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, legally imperfect benefit changes or 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. Here are a few practical suggestions on how to resolve the knotty issues.

1 Aligning administrative processes

Trustees will generally aim to achieve a good 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 prerequisite, 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.
- 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.

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 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. This is not typically an option provided by most insurers.

3 GMPs

While the market is evolving rapidly, it remains the case that insurers have a strong preference for a GMP equalisation methodology which does not require them to maintain dual records. Trustees will want to consider how they plan to address their obligation to equalise for the effect of GMPs and whether this is likely to be something an insurer will be able to support at buy-out.

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 part of their defined benefits. Typically, a buy-out will involve the transfer of the defined benefits to the insurer, but not any money purchase 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)

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 the member data provided to it.

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

6 Tax protections

The buy-in / buy-out process (including, where relevant, GMP equalisation) currently presents some areas of uncertainty in relation to members with tax protections. Though these issues are expected to be resolved or clarified, trustees will want to consider identifying members with tax protections in advance, where possible, and whether to seek clarification of the position.

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 solutions

2019 was a busy year in the longevity swap market. Amongst other transactions, we advised the trustees of the HSBC Bank (UK) Pension Scheme on one of the largest transactions to date, and the first intermediated through a Bermuda captive insurer. We also advised the trustees of a scheme on a transaction to fold their longevity swap into a buy-in. Based on this experience, these are some of the key points which are worth looking at and understanding upfront when considering a potential transaction.

Choosing an intermediation structure

The lead players in the market are the reinsurers. A decision needs to be made about the best way to access the reinsurance market. The following are potentially available:

1. bespoke captive insurer owned by the trustee or the sponsor
2. “off the shelf” captive – an insurance cell set up and maintained by a third party provider but owned by the trustee
3. a commercial UK insurer-offered pass-through structure, where a third party UK insurer intermediates between the trustee and the reinsurer but does not take the risk of the reinsurer defaulting
4. a commercial UK insurer offering full cover (similar to option 3, but taking the risk of the reinsurer defaulting).

We have listed the options above in order of complexity. A key part of the analysis is that the more bespoke solutions require more intensive effort to put in place and to operate once they are up and running, but they potentially offer advantages in terms of flexibility and cost.

A captive structure under option 1 or 2 will need to be (and remain) offshore if it is not to be subject to UK regulatory and capital requirements. Longevity swap captives have therefore tended to be set up in Guernsey or Bermuda.

Credit risk

These are long-term transactions and it is important to consider how to mitigate credit risk. Longevity swaps therefore tend to be collateralised, except for some transactions that are run through regulated UK insurers, and have carefully negotiated termination events to make sure that each party can terminate the transaction and access collateral in appropriate circumstances.

A balanced approach needs to be taken to termination events in a long-term transaction. They need to be tight enough to provide sound credit protection but not so tight that they create hair triggers when there is an issue that can be resolved.

The collateral structure may need to be adapted depending on the intermediation structure used and the location of the reinsurer. It is important to think flexibly about this and to consider whether there are ways to avoid complexity without compromising security.

Flexibility

For many schemes, a longevity hedge is one step in the broader derisking journey towards a buy-in or buy-out. Trustees will want to make sure that the transaction's terms maximise the potential for a successful transfer, or "novation", of the longevity swap to a bulk annuity provider, as part of the buy-in or buy-out transaction. This needs to be considered as part of the structuring of the contract. Whilst reinsurers can never guarantee that a novation will be successful, it is possible to agree terms as part of the longevity swap documentation that will facilitate this and, for example, include a commitment by the reinsurer to novate if certain conditions are fulfilled.

We have significant experience with a variety of transaction structures and have negotiated positions on the above issues with a number of reinsurers. We have also been heavily involved in developing the structures of the transactions. We help trustees navigate this tricky area in order to ensure that the longevity hedge does not become an impediment to fulfilling a scheme's journey down the line.

What our clients say

HSBC Bank (UK) Pension Scheme closed a £7bn longevity swap with PICA

£7bn

Sackers in-depth knowledge of the scheme, as well as their clear and responsive advice, enabled the Trustee to overcome significant obstacles to complete the deal and secure members' benefits.

RICHARD WILLIAMS, HSBC PENSION SCHEME EXECUTIVE

GEC 1972 Plan (sponsored by telent) completed a £4.7bn buy-out with Rothesay Life

£4.7bn

Sackers provided excellent support to the trustees during the process, as they have done over many years.

BRIAN DUFFIN, CHAIR OF TRUSTEES, GEC 1972 PLAN

AIB £1.1bn buy-in and assured payment policy

£1.1bn

These transactions represent a major milestone in derisking the Scheme and are the result of a collaborative process between the Bank and the Trustees over many years. Neither would have been possible without the constructive input and clear advice of Sackers, our long-standing legal advisers, whose experience of these transactions instilled confidence and helped us to achieve our objective of improving the security of members' benefits.

NORBERT BANNON, CHAIR OF TRUSTEES, AIB

Electricity North West Group completed a £805m pensioner buy-in with Scottish Widows

£805m

The Group's funding level has improved significantly in recent years and this transaction allows us to lock in some of that positive performance providing security to our members and other stakeholders. Sackers effective and expert advice enabled us to successfully deliver the buy-in.

MALCOLM SUGDEN, CHAIR OF TRUSTEES, ELECTRICITY NORTH WEST GROUP OF THE ESPS

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.

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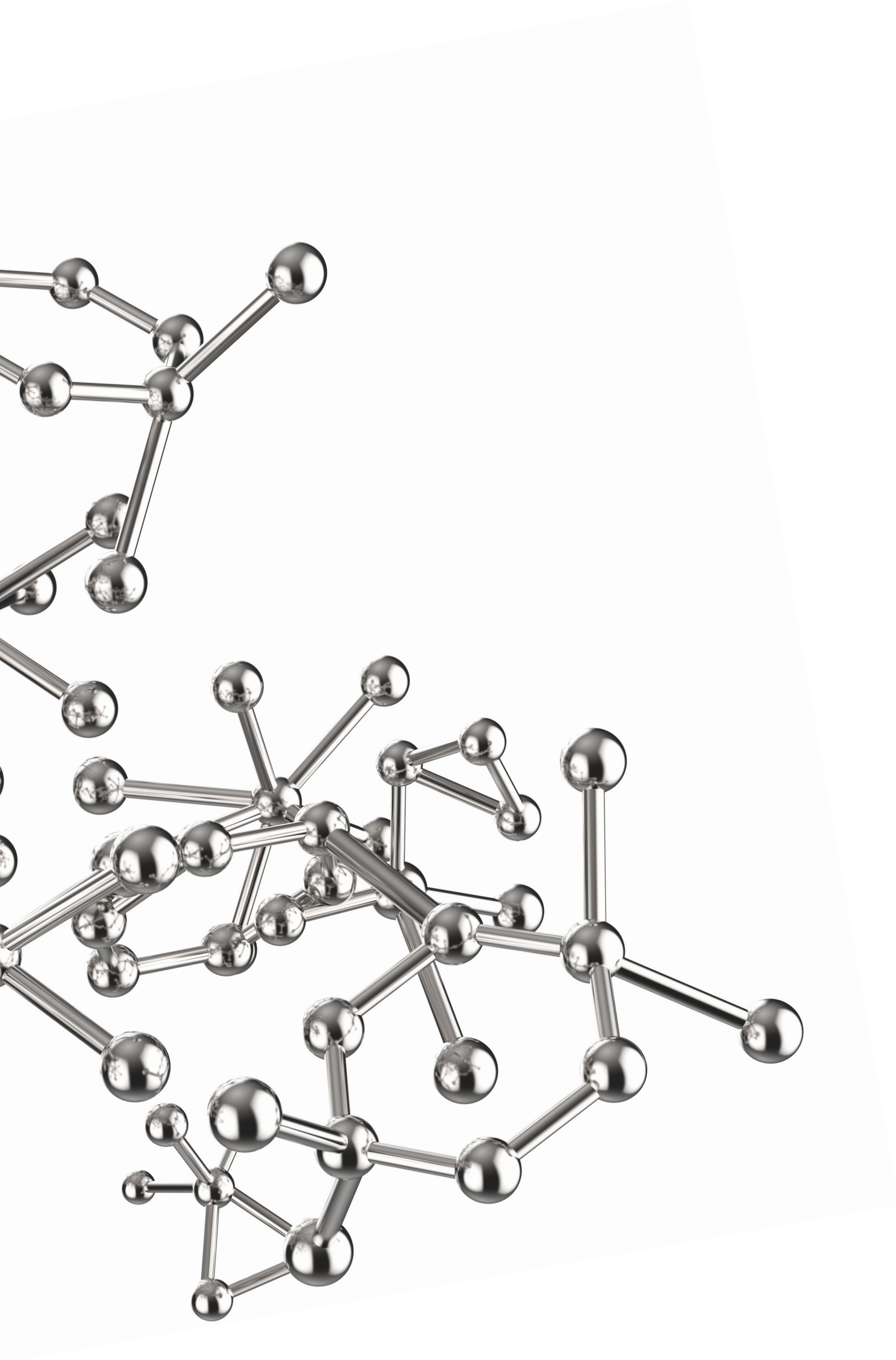

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