The journey to buy-out

COMING INTO FOCUS

Rothesay life

INTRODUCTION

At the end of 2016 Rothesay Life produced its first buy-out report. £25bn of defined benefit liability had transferred to insurance companies in the preceding two years, and new capital regulations for insurers, under Solvency II, had just come into force. The pensions press were focused on the implications of the collapse of BHS and Tata Steel, but momentum for pension scheme de-risking was growing and the survey we conducted, as part of that report, showed demand was likely to increase further.

As 2019 came to a close, we decided it was time to revisit that report, and to look again at the de-risking market at this point in time.

2019 was a record breaking year for bulk annuities. The market saw over £40bn of pension liability transfer to insurers, a figure that may have seemed inconceivable for the market to achieve in 2016. Improved funding levels, a slowdown in longevity improvements, continuation of sponsor contributions and the maturing of schemes meant what had once seemed a distant spot on the horizon is now

coming into focus

for increasing numbers of schemes and their sponsoring employers.

Whilst it's unlikely that £40bn is the new norm, it is clear that the marketplace has changed and endgame planning is now an agenda item in most trustee meetings.

In this publication we have worked with a host of industry experts to bring together a series of articles that take you on the journey to buy-out. Each scheme's journey will be different but the fundamentals are common for all.

Alongside the articles we also present the results of an updated survey that we have completed with our friends at mallowstreet. The results show that 42% of pension funds are already targeting buy-out for their endgame. Larger funds are becoming interested in buy-out too with 28% of schemes over £1bn in the survey targeting buy-out.

We hope that you find this report insightful and helpful and we look forward to working with many of you over the years ahead.

The journey to buy-out overview

What was originally an important (and relatively inexpensive) employee hiring and retention tool in the 1960s, has, for most sponsors, become a very expensive legacy issue.

Operating occupational defined benefit pension schemes involves managing large and complex financial risks, it requires significant operational costs and uses up valuable management time that could be better spent running the sponsor's business. It is not surprising therefore that the aim of most sponsors is to move to a position where these risks can be safely managed by someone else.

De-risking has been the focus for most pension schemes for many years, however the way to reduce risk did not always lead schemes down the same path or to the same destination. Schemes have adopted many different approaches – but common to all their journeys was the desire to remove risk from their scheme in a balanced way and, above all, to protect members' benefits.

While every scheme will find itself in a unique position from a size, maturity and employer covenant perspective, each one has the same overall aim: to deliver the benefits that their members were promised. And 15 years ago, when the marketplace was in its infancy, the endgame of buy-out probably seemed to be decades away.

Legislation and regulation across any marketplace have a tendency to drive changes in behaviour and there can be little doubt that the introduction of the Pensions Regulator (TPR) and the Pension Protection Fund (PPF) in 2005 was a huge catalyst for the buy-in and buy-out market. Trustees and sponsors have had to agree funding plans and review their performance against these every three years, and as a result we have seen a wall of money move into UK defined benefit schemes. This, coupled with the slowdown of longevity improvements over the last few years and positive returns in most asset classes, has meant that many scheme funding levels have improved dramatically. With TPR's focus on endgame planning just around the corner, we can see this trend continuing in the coming years.

No scheme is the same and each is on their own journey with a different story to tell. With this in mind it's no wonder that we see many different needs and requirements from the bulk annuity market. In this publication we have explored in depth the journey to buy-out and the many avenues schemes may take to get there. Regardless of where your own scheme is on its journey we think this publication will be an interesting read.

SECURITY OF INSURANCE

Back in 2007, when the buy-out market had ten competing firms, we saw a total of £3bn business transact. In 2019, we saw £44bn of buy-in and buy-outs completed, including five deals over £3bn in size. The willingness of trustees to transfer so much liability to insurers is testament to the strength of the covenant afforded by insurers. Whether it be a buy-in or a buy-out, understanding the financial strength of the insurers is often a key part of a trustee's process, and thoughts on this topic can be found on pages **72** and **74**.

THE STEPS TO BUY-OUT

Many schemes decide to start with a pensioner buy-in, perhaps even a complete series of buy-ins over a number of years in the manner of National Grid and ICI before reaching buy-out, but is starting with a buy-in a good idea? We have explored this topic on page **16**. Another starting point is for schemes to first protect themselves from longevity risk through a longevity swap, and we have since seen schemes such as Rolls-Royce and MNOPF who put these swaps in place to hedge longevity look to convert these swaps to a buy-in. Page **52** looks at the steps involved in converting a longevity swap and the interaction with the bulk annuity market.

We also hear directly from a reinsurer on page **56** about reinsurer appetite for UK longevity business, whether that be transacting with a scheme or providing reinsurance for the insurer.

Some schemes, through careful risk management, are able to secure a buy-out for all the liabilities in one transaction. Buy-outs however come with many more complexities than a buy-in and on page **24** we detail additional considerations a trustee should think about when completing a buy-out.

TOP 20

Transactions in the bulk annuity market

Name	Size (£m)	Sector	Insurer	Date	Type
GEC 1972 Plan (telent)	**4,700**	Technology	Rothesay Life	Sep 2019	Full buy-in to buy-out
Rolls-Royce	**4,600**	Automotive	Legal & General	Jun 2019	Pensioner buy-out
British Airways	**4,400**	Airline	Legal & General	Sep 2019	Pensioner buy-in
Allied Domecq (Pernod Ricard)	**3,800**	Drinks producer	Rothesay Life	Sep 2019	Buy-in
Asda	**3,800**	Retail	Rothesay Life	Oct 2019	Full buy-in to buy-out
British American Tobacco	**3,400**	Tobacco	Pension Insurance Corporation	Aug 2019	Buy-in
ICI	**3,000**	Chemicals	Legal & General	Mar 2014	Pensioner buy-in
National Grid	**2,800**	Utilities	Rothesay Life	Oct 2019	Pensioner buy-in
TRW	**2,500**	Automotive	Legal & General	Nov 2014	Pensioner buy-out
Nortel Networks	**2,400**	Technology	Legal & General	Oct 2018	PPF+ buy-out
Philips	**2,400**	Technology	Pension Insurance Corporation	Nov 2015	Full buy-out
Aviva	**1,700**	Insurance	Aviva	Oct 2019	Pensioner buy-in
Civil Aviation Authority	**1,600**	Public	Rothesay Life	Jul 2015	Pensioner buy-in
MNOPF	**1,600**	Shipping	Pension Insurance Corporation	Feb 2020	Pensioner buy-in
National Grid	**1,600**	Utilities	Legal & General	Nov 2019	Pensioner buy-in
Total	**1,600**	Oil and gas	Pension Insurance Corporation	Jun 2014	Pensioner buy-in
EMI	**1,500**	Music entertainment	Pension Insurance Corporation	Jul 2013	Full buy-out
Rentokil Initial	**1,500**	Business services	Pension Insurance Corporation	Dec 2018	Full buy-in to buy-out
Siemens	**1,265**	Manufacturing	Pension Insurance Corporation	Jun 2018	Pensioner buy-in
Dresdner Kleinwort	**1,200**	Financial services	Pension Insurance Corporation	Apr 2019	Full buy-in

PREPARING TO COME TO MARKET

The importance of preparation is echoed throughout the marketplace and something we regularly talk about. Often trustees spend years preparing and planning to bring their scheme to market. We have therefore included a series of articles that explore why preparation is paramount (page **20**), data and benefit considerations (page **26**), how to judge feasibility (page **12**) and how to ensure the scheme assets are suitable for a smooth and orderly asset transfer (page **42**).

Whichever route a scheme decides, they will need the right advisers by their side and a good relationship between the trustee and the sponsor with open communication channels. We hear how important this is from the view of an independent trustee on page **10** and also consider in more detail what issues are likely to be important to the sponsor on page **30**.

The preparation the scheme does before coming to market is evident to insurers and on page **34** we give a few inside tips on what will get you noticed in a busy marketplace. Understanding the bidding process and what to look for in an insurer's proposal can also help trustees ask the right questions and get the outcome they desire for their scheme. It's worth reading pages **66** and **68** to find out more.

SCHEME SPECIFICS

Scheme factors versus insurer factors is also often a topic of debate for buy-out transactions (page **38**) as well as considering whether to secure any additional risk cover, over and above the known liabilities of the scheme, such as residual risks cover (page **44**). Rothesay Life completed the largest buy-out to date with telent in 2019, on page **82** we explore this scheme's journey to buy-out and how they were able to achieve such a good outcome for their members.

Some schemes will run member option exercises in the hope of bridging the final gap between their funding level and insurer pricing, but have you considered how this will affect an insurer's pricing basis and the potential impact on the final premium? Page **40** looks at how such exercises may be reflected by insurers.

GETTING THE DEAL DONE

It's easy to think that once you have selected your insurer that the deal is done and you've crossed the finish line, but hold your horses there's still a bit of work to do. From exclusivity to inception is a key time for all transactions. The price-lock is ticking away while contract negotiations take place and operational implications are worked though. Chapter five considers administrative and operational processes that will be in place once the contract is signed. There's also some hints on what to look out for in the contract negotiations (page **76**).

Delivering the good news to members that you have further enhanced the security of the benefits through a buy-in or a buy-out sounds like an easy task, but this isn't always true. Making sure that member communication is clear and balanced and describes the transaction in a way that the member understands is an acquired skill. On page **92** communication experts Quietroom give us a lesson on good communication which is worth a read.

SPONSOR INSOLVENCY

There are of course some unfortunate instances, where despite best endeavours schemes find themselves with a sponsor who has become insolvent, leading to a lengthy process of PPF assessment. However, if the scheme assets are sufficient, the scheme may have the opportunity to secure "PPF+" benefits with an insurer (or possibly a consolidator!). You can read insights into what makes these processes different and what you may need to think about if you find yourself in this position on page **60**.

UNDERSTANDING THE JARGON

Finally, for those of us who might not be able to keep up with all the industry lingo we have included a glossary of terms at the back of the publication.

YOUR TEAM AT ROTHESAY LIFE

Sammy Cooper-Smith

Cleo Taylor Smith

Guy Freeman

Róisín O'Shea

Tom Seecharan

The Business Development team at Rothesay Life works with pension scheme trustees, sponsoring employers and their actuarial and legal advisers in order to structure and negotiate pension scheme de-risking transactions that are bespoke to each client.

We would be delighted to speak to any scheme about the journey and process to buy-out irrespective of current funding level or size of scheme.

Contact details are at the end of the publication.

Getting started

Chapter 1

MALLOWSTREET
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Pension Risk Transfer Report

42%

of schemes are working towards buy-out

"In a fast moving and complex environment, it is critical for trustees to be well advised."

Getting started: trustee considerations

TRUSTEES SHOULD BE PREPARING TO BE BUY-OUT READY, EVEN IF THEY ARE NOT AS CLOSE TO THEIR TARGET AS THEY WOULD LIKE TO BE.

Many, if not all, trustees would be delighted to inform their DB pension scheme beneficiaries that their benefits had been secured with a reputable and financially stable insurer. Delivering this gold standard of security can only be achieved through working in partnership with those who understand the insurance market and can guide trustees through their de-risking journey.

In a fast moving and complex environment, it is critical for trustees to be well advised when considering any form of risk reduction as opportunities may arise at any time and trustees and employers should be ready to move as they have ideally been working jointly on strategy and are aware of when an opportunity presents itself.

Given the plethora of risk reduction options to choose from in the pensions world, it is vital that trustees have undertaken their due diligence and engaged with the sponsoring employer well in advance when deciding that transacting with an insurer is their solution of choice. This will largely be determined by the scheme's funding level, the types of assets held and potentially the employer's covenant and its desire of how much cash it is willing to inject (and with what certainty) to move the pension risk off its books.

Depending on the size and structure of the trustee board, it is critical that there is a key point of contact that can programme manage such an exercise and oversee the various projects that will need to interact. Drawing these strands together on the trustee side, including administration, investment, legal as well as a transaction specialist, is labour intensive and trustees should look to see if they have the capacity and capabilities within their own governance model as well as in their current advisory set-up. This is also where professional trustees can often add real value to the process.

Ideally, being able to draw upon dedicated and specialised teams to help run a buy-out is preferable as it is vital that any business-as-usual activity is not impacted and the "member experience" remains positive. The accuracy and robustness of data makes a scheme more attractive to insurers, therefore there may be more administration input required than normal.

Keeping the sponsoring employer involved and informed throughout the project is best practice. Working with advisers that have a good relationship with, or are known by reputation to, the employer will ensure positive engagement and also help manage employer expectations around timescales to fully buy-out and eventually wind-up a scheme.

There are various mechanisms that can be used when determining what and how a deal with an insurer can be achieved. This includes knowing the price, i.e. the cash injection is needed; are there flexibilities in what percentage of premium to be paid; is there a price-lock on offer; and what risk will an insurer be willing to accept? Another area where trustees are often not as comfortable, is the balance of powers under the scheme compared to an insurance policy and how scheme options may be slightly different to those from an insurer.

Working with professionals with extensive insurer transaction experience will assist with navigating through these areas, as well as shortlisting the insurers with the appetite to do a deal based on size of transaction; the make-up of the membership; and potentially brand value.

It almost goes without saying that a detailed project plan would have to be in place and tracked on a frequent basis. There are many small details that need to be considered and having a cool head (or heads) amongst the trustees and advisers will allow all actions and risks to be considered.

Taking the time to select the best advisers (whether incumbent or new to the scheme) for a buy-out project will help trustees achieve best outcomes and result in the selection of an insurer that provides the beneficiaries with the security they desire.

It is therefore key to be buy-out ready with buy-out specialists.

SHEHZAD AHMAD
Ross Trustees

Shehzad is a professional trustee at Ross Trustees and has over 15 years' experience in trusteeship. His clients include household names, with assets ranging from the low millions to several billion and he has led numerous de-risking exercises, including member options and insurance transactions. He is well known for his collaborative style which has allowed him to recently go to the insurance market and execute a deal within two weeks. Shehzad is a member of the APPT and PMI.

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13%

of schemes think they will reach their endgame within 2 years

Judging feasibility

A ROBUST FEASIBILITY ASSESSMENT SHOULD ALWAYS BE UNDERTAKEN AT THE OUTSET OF A BUY-IN OR BUY-OUT PROCESS.

Assessing the feasibility of a buy-in or buy-out is an essential part of the process, allowing a pension scheme to make an informed decision about whether it is worthwhile spending management time and expense on an exercise. Also, in a market where insurers are having to turn away business, insurers will focus their energy, time and money on processes that are likely to lead to a transaction. Demonstrating completion of a robust assessment of feasibility gives insurers confidence that your scheme will ultimately transact.

Feasibility assessments generally boil down to a few key considerations which I'll explore in turn. While buy-in and buy-out often get mentioned in the same breath, from a pension scheme's perspective they couldn't be further apart, and judging feasibility looks very different. This has been reflected in the considerations following.

Judging feasibility

"While buy-in and buy-out often get mentioned in the same breath, from a pension scheme's perspective they couldn't be further apart, and judging feasibility looks very different."

BUY-IN CONSIDERATIONS

Funding the buy-in
Specific assets should be earmarked for the transaction, with due consideration for any rebalancing of residual assets which may be needed after a transaction to maintain suitable overall target returns and levels of leverage. Schemes should be comfortable they will have sufficient liquidity to meet potential collateral calls in respect of any derivatives used within the portfolio.

No expected impact on the viability of future buy-in transactions
Schemes should ensure any buy-in is not expected to hinder their ability to insure further liabilities in future. For example, insuring all pensioners now may make a final transaction covering current non-pensioners less attractive to some insurers, until the point in the future at which enough of the deferred members have retired.

Consistency with long-term objectives
If a scheme has a longer-term buy-out objective, it should look at a projected funding journey with and without the buy-in, to ensure the buy-in supports that journey.

BUY-IN AND BUY-OUT CONSIDERATIONS

Clear, realistically achievable maximum affordable price
For a buy-in, the assets being used will determine buy-in pricing required to ensure overall expected returns are not reduced. This means a better price will be needed if the buy-in is funded from higher yielding assets. Schemes may be willing to accept a reduction in expected return in exchange for the additional protections afforded by a buy-in, including longevity and demographic risk cover and precise cashflow matching. Furthermore, some schemes will have scope to de-risk their asset portfolios and therefore a buy-in may not need to deliver the same implied yield as the assets being used to fund it.

Schemes need to think carefully about which demographic assumptions to use when determining the implied yield of a buy-in. For example, if a scheme uses an out of date longevity assumption and life expectancy has since fallen, the buy-in would look more valuable than if this assumption were updated.

For a buy-out, the price simply needs to be affordable using the scheme's assets, plus any cash the sponsor is willing to pay, allowing for contingencies and the costs of finalising wind-up.

For both buy-ins and buy-outs, once a scheme has determined what price is needed in its own circumstances, this can be compared with current market pricing to see if the scheme's targets are realistic.

Accounting implications are acceptable to the sponsor
Both buy-ins and buy-outs can have an adverse impact on company balance sheets, but the accounting treatment of this balance sheet adjustment can be less favourable for buy-outs, potentially hitting the sponsor's profit and loss account for that financial period. Sponsors need to get comfortable with this early on to avoid potential roadblocks down the line. Accounting implications will be explored in a later section.

Adequate governance in place
Generally, a "Joint Working Group" will be set up with both trustees and sponsor represented, tasked with the day-to-day management of a buy-in or buy-out project alongside advisers. Clear, documented delegations of authority are needed at the outset.

"Schemes should ensure any buy-in is not expected to hinder their ability to insure further liabilities in future."

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62%
do not expect insurance pricing to get cheaper in the future

CLOSING REMARKS

The relative weighting given to each of the above considerations will vary from scheme to scheme, and for most schemes it will be a case of balancing a number of them in order to determine the feasibility of a buy-in or buy-out.

MICHAEL ABRAMSON
Hymans Robertson LLP

Michael is a Partner at Hymans Robertson specialising in pension risk transfer. He has led some of the largest buy-ins and buy-outs, including the Allied Domecq Pension Fund's £3.8bn buy-in with Rothesay Life.

Pensioner buy-ins: A sensible de-risking step or a hindrance to ultimate buy-out?

For many schemes there has been a move towards pensioner buy-in transactions as a de-risking step as schemes progress on their de-risking journeys and seek to reduce the risk to member benefits.

Pensioner buy-ins

Is this, as many schemes believe (and as has been the case for seven of the 20 largest full buy-ins/buy-outs), a sensible step along a path to full buy-out?

Or does it make securing benefits in full at the point of final buy-out harder, not easier?

It is first worth a reminder of the reason why pensioner buy-ins have been so popular. Pensioner buy-in pricing has been attractive for a number of years, with pensioner buy-ins funded from gilt holdings typically leading to an improvement in a scheme's funding positions with no sponsor cash required.

A series of buy-ins over time can also be an efficient risk management. Let's look briefly at a couple of key points.

As schemes move towards lower risk investment strategies, longevity risk becomes increasingly dominant. A pensioner buy-in offers a way to hedge longevity in incremental steps; in the same way that schemes have slowly increased interest rate and inflation hedging over time. Reducing longevity risk in this way can be more efficient as it avoids any single risk becoming dominant.

Another risk addressed by buy-ins is insurer pricing risk. A worsening in pricing could happen for a range of reasons, for instance due to changes in regulation. Arguably the biggest risk for many schemes' journey plans is that insurer pricing increases in the future by, say, 5% making full buy-out unaffordable. A series of buy-ins provides protection against a worsening in future pricing, helping schemes lock into the average pricing over time. This approach is no different from any large investment, spreading the investment helps smooth out pricing volatility.

For larger schemes a series of smaller buy-ins can be more cost effective than a single "mega" transaction. Insurers only have a limited pipeline of attractive assets to support their best pricing. So, by being flexible, a well organised scheme can seize those pricing opportunities as they arise. In contrast, a single mega transaction will be very reliant on the assets insurers have available at the time.

Lastly, pensioner buy-ins also have softer benefits. A full buy-out is a complex transaction, so undertaking a more straightforward initial pensioner buy-in is a valuable learning experience. It is also a clear demonstration to the market that the scheme is well prepared and willing to transact.

Despite the benefits of buy-ins, there are pitfalls to avoid which, if not properly navigated, can ultimately make it harder for the scheme to move to buy-out.

For instance:

1. **Reduced level of engagement from the wider insurance market; or**
2. **Allocating more assets to the pensioner buy-in that the scheme can afford; or**
3. **Costly/difficult to insure residual liabilities; or**
4. **Restricting options for residual risk cover on buy-out.**

Firstly, obtaining strong insurer engagement is central to achieving the best pricing. Approaching the market for subsequent transaction(s) needs to be done carefully. Other insurers may view the incumbent insurer(s) as having an advantage in any transaction and so be less likely to agree to quote, or to allocate their best assets to the pricing. It's therefore important to consider this upfront.

But having an existing buy-in can also be very positive. Building strong relationships with insurers through an initial buy-in can have powerful benefits. For larger schemes, appointing a panel of insurers with umbrella contracts as part of a phased buy-in strategy, can provide better engagement from key insurers. This approach has been adopted by, for instance, ICI and Pearson. Even for smaller schemes, it is possible to ensure the wider market is interested in participating; LCP has plenty of recent experience of helping trustees with existing buy-ins get engagement in the market and secure buy-out with a different insurer.

Secondly, it is vitally important for any pensioner buy-in to be sized appropriately. This is to ensure the remaining invested assets can generate sufficient return to close the gap to buy-out over the desired timeframe, whilst providing sufficient collateral for the wider hedging strategy.

The other risk arising from undertaking a pensioner buy-in is that you are left with an expensive, difficult to insure set of residual liabilities. Insurer appetite for non-pensioner liabilities has improved in recent years but they remain more expensive and are best insured alongside pensioner liabilities to provide balance.

Before entering into an initial buy-in, consider how the scheme's membership profile and asset strategy will evolve over time as that is key to sizing the initial buy-in and when to extend it in future. But be reassured that even if you do reach full buy-out quicker than expected, we have achieved attractive pricing recently for several deferred heavy schemes (for instance the Post Office scheme was almost entirely non-pensioners).

The final potential issue is the availability of residual risks cover (which covers the cost of correcting any inaccuracies in data/benefits found in the future) from the chosen insurer at the point of buy-out. This cover is purchased in a majority of full buy-ins/buy-outs over £250m and typically comes into effect at the point of the final buy-out. This cover involves intensive due diligence on the data and benefits to agree the price and terms and if this is not completed as part of the initial buy-in when there is competitive tension then it may result in less favourable terms, or even no cover at all, from the incumbent insurer at the point of buy-out. There have been innovative solutions in specific cases (e.g. the insurer for the final transaction providing "wrap-around" cover across all existing buy-ins).

However, where residual risk cover will be important, it is worth considering this as part of the initial buy-in noting the additional work involved, particularly on data/benefit due diligence.

So in conclusion, is a pensioner buy-in a hindrance to full buy-out? Not if done properly; a phased buy-in strategy can help schemes reach full buy-out with greater certainty and at a lower overall price.

DAVID SALTER
LCP

David is a Partner in LCP's de-risking team, with a focus on helping schemes plan and implement their de-risking journeys. He has led a number of full buy-ins including for Commerzbank in early 2019 and helped Philips complete a £3.5bn series of buy-ins culminating in full buy-out.

Preparation is paramount

DEAL PREPARATION AND ENGAGING INSURERS

"Preparation is paramount" is a common mantra of consultants, lawyers and insurers when it comes to successfully achieving trustee and sponsor objectives in the bulk annuity market. What does this mean in practice for schemes? Why is it so important?

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85%

of schemes have checked their member data

Preparation is paramount

DEAL PREPARATION AND ENGAGING INSURERS

LAYING THE FOUNDATIONS

For most bulk annuity transactions, the trustees will be asking the insurer to take on responsibility for the specified pension benefits due to the scheme's beneficiaries in the years to come. This means that the trustees must have a very good understanding of the benefits which should be paid.

This relies on two fundamentals:

1. Materially complete and accurate data
2. Clear knowledge of benefits payable

These are the foundations that underpin the entire transaction process from robust pricing and agreement of suitable contractual provisions, through to transaction implementation. Of course, insurers appreciate the significance of these building blocks and will factor them into their assessment of any transaction coming to market. Demonstrating the scheme has invested time to prepare gives the insurer the reassurance of a well-governed process and supports their prioritisation of the transaction.

These foundations may seem obvious.

You can be forgiven for thinking that surely all well run schemes would have accurate data and know what benefits have been promised. Whilst it may be true, insurers look for additional information not required for day-to-day administration, which can also help with liability pricing. This includes data about marital status and reliable historical mortality experience. Beyond this, under the policy the trustees will have to give some legal commitments regarding the accuracy of the data provided, and so having appropriate upfront preparatory steps help avoids potential pitfalls later in the transaction process.

Giving insurers information about the scheme benefits is typically done using a comprehensive benefit specification. It allows insurers to fully price the benefits being secured, and must dovetail with the supporting membership data provided. As part of these preparations, trustees will typically look for legal confirmation the benefit specification is in line with the pension scheme's rules to give comfort that the benefits being priced and ultimately insured are correct. Trustees will also need to consider how any discretionary practices in the scheme's rules should be addressed for transaction purposes, making sure that insurers provide consistent quotations which reflect the benefits to be insured. For some transactions where the intention is to remain in the buy-in phase for a significant period, a conscious decision may be made to insure a slight variation of the scheme benefits or it may be appropriate for the treatment of discretionary practices under the buy-in to differ from the day-to-day scheme operation. In these circumstances, careful thought is required on how any gaps in the insured benefits will be addressed before the ultimate transition to individual policies and scheme wind-up, including agreement of suitable contractual flexibility.

DESIGNING THE PLAN

Like most multimillion pound projects, detailed planning is key for an efficient bulk annuity transaction. Insurers will look for a clear route to contract signing and execution. This means being able to articulate to the market what decisions will be made and when. Providing this visibility gives insurers confidence that their investment in providing quotations will ultimately lead to a transaction – this helps to further cement insurer engagement.

That said, plans for the sole purpose of generating engagement is not the point. Transaction plans should be practical, well considered and ultimately deliver for all stakeholders. Even the simplest of transactions will quickly unravel if the intended route, or decision making structure, doesn't work for a key stakeholder. It is important all key stakeholders understand the transaction process and what decisions will need to be made, including any specific trustee or sponsor issues being identified and considered sufficiently early on in the process.

"Demonstrating the scheme has invested time to prepare gives the insurer the reassurance of a well-governed process."

"Insurers will look for a clear route to contract signing and execution. This means being able to articulate to the market what decisions will be made and when."

POTENTIAL AFFORDABILITY

Insurers will engage in potential transactions that are expected to be affordable. In 2019, Barnett Waddingham's research showed that one of the key reasons behind insurers declining to provide quotations was due to an unrealistic price target, as this in itself will mean that a transaction is unlikely to happen. So what can trustees and sponsors do to best prepare in this regard?

Experience shows that undertaking a realistic feasibility study can be helpful for a scheme that is eyeing a transaction. In particular, this is the time to ensure that there is an open dialogue between trustees and key decision makers within the sponsor – this can be constructive in understanding affordability and serve both parties well as the transaction process progresses. Approaching the bulk annuity market for quotations is typically best done when a transaction is expected to be within potential reach (possibly aided by additional sponsor funding), as purely speculative market approaches may impact insurer engagement further down the line (avoiding insurers showing no interest when your transaction is actually in a position to complete).

ACCESSING AGILITY

During 2019 and into 2020, trustees and sponsors that were able to respond quickly to opportunities have been rewarded in an increasingly dynamic bulk annuity market. Even with the best laid plans, markets can move, insurer appetite can change, and transaction windows can be relatively fleeting.

Importantly, having solid foundations; a robust plan with clear decision making routes; and a good understanding of what affordability looks like for all stakeholders, paves the way for trustees and sponsors to be agile and responsive to changing circumstances, such as transaction timings, which may need evolve to respond to potential market opportunities.

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Pension Risk Transfer Report

55%
of schemes with a weaker covenant favour buy-out

ROSIE FANTOM
Barnett Waddingham

Rosie is a Partner at Barnett Waddingham, specialising in pension scheme de-risking, predominately focusing on the bulk annuity market. She spends the majority of her time advising corporate and trustee clients on how to achieve their objectives when it comes to insuring defined benefit liabilities, and has over 12 years' experience in this space.

What to think about when completing buy-outs

At Rothesay we have insured many of the largest buy-outs. Our experience has taught us that completing such a transaction is a challenging task. The thinking required on a buy-out goes way beyond the far simpler approach that is needed for pensioner-only buy-ins. So what is it that makes buy-outs different from the better understood pensioner-only buy-ins?

ALL OF THE PENSION FUND ASSETS ARE NEEDED

A key aspect is that virtually all of the pension fund assets will be used up to pay the premium to an insurer for a bulk annuity. A small amount of assets will need to be retained by the trustees to cover the costs of administration and advisory fees to complete a wind-up. Sometimes additional funding is required from the sponsor to bridge a shortfall.

TOP 15

Full buy-outs announced since 2006

Name	Insurer	Tranches	Size (£m)	Date
GEC 1972 Plan (telent)	Rothesay Life	Single	4,700	Sep 2019
Asda	Rothesay Life	Single	3,800	Oct 2019
Philips	PIC, Rothesay Life & Prudential	Multiple	3,500	Nov 2015
Rentokil	PIC	Single	1,500	Dec 2018
EMI	PIC	Single	1,500	Jul 2013
MNOPF (Old Section)	Rothesay Life & L&G	Multiple	1,300	Dec 2012
Vickers Pension Scheme	L&G	Single	1,100	Nov 2016
Thorn	PIC	Single	1,100	Dec 2008
Dockworkers	PIC & L&G	Multiple	875	Dec 2017
PA Consulting	PIC	Single	855	Jun 2018
Rank	Rothesay Life	Single	700	Feb 2008
Lehman Brothers	Rothesay Life	Single	675	Apr 2015
NCR	PIC	Single	670	Nov 2013
Western United	Rothesay Life	Multiple	500	Jun 2014
Post Office	Rothesay Life	Single	450	Jul 2017

Note: PPF+ deals and buy-in deals where a buy-out has not yet been announced have been excluded from the above table

Unless the fund is in the rare situation of having a surplus, all of the pension fund assets will be needed. This has two important consequences. The trustees will need to pay close attention to:

- any assets that can't be transferred to insurers or are illiquid as these could delay insurance; and
- how the fund will cover its cashflow commitments once the bulk annuity is in place to ensure all payments are made to the members on time as usual when the trustees no longer have a liquidity buffer.

CAPTURING THE MOMENT IS NOT SIMPLE

Buy-out transactions involve significant risk transfers to insurers. There will be volatility between the insurer's premium and the value of the pension fund assets. Pension fund liabilities typically have durations over 20 years and the contribution from the sponsor required to bridge the shortfall in the fund's assets can be highly sensitive to movements in interest rates, inflation expectations and asset values as well as to movements in the insurer's buy-out premium. Company boards will often have a fixed budget for their contribution to fund a buy-out and a planned transaction can quickly move in or out of affordability. So how do you capture the moment and ensure a transaction can be completed within agreed targets for costs? Careful planning is required to capture the desired outcome.

HAVE WE COVERED ALL OF OUR LIABILITIES?

Part of ensuring that a transaction works for the trustees and the sponsor is to be confident that all of the pension fund's liabilities are covered for the price quoted and nothing is missed out, or at least there are funds set aside to cover any additional cost and a solution for anything not covered by the insurer. A sponsor will often be making a large contribution to facilitate a buy-out and won't want any unexpected, additional costs arising in the future. So work needs to be done to ensure that no members are omitted and that the benefits paid in the past and secured by the insurer in the future match the member's entitlements. This is much harder than it sounds.

WHAT HAPPENS IN THE RUN-UP TO ISSUANCE?

As buy-out is the aim, it will be necessary to think about what happens in the period between signing a bulk annuity with the insurer and converting this bulk annuity into individual ones held by the members and completing wind-up. Once the individual policies have been issued, the trustees have no further obligations to pay any pension benefits. The pension scheme can then complete its wind-up and the sponsor can return its full attention to running their business.

Again this sounds simple but there are many tasks to complete not least a transfer of administration and GMP equalisation. The steps to buy-out need to be fully understood and factored into the design of how the bulk annuity contract will operate.

THE EFFECT ON MEMBERS

Trustees will focus on the how the members are affected and the most obvious change is that a different party will be paying their pensions each month and they will be dealing with a new administrator. Trustees will want to know that their members will be treated well and that the new administration processes are robust and reliable and that the handover doesn't create step changes, for example in tax codes.

It is not only about administration for the members though. The terms for any member options are also very likely to change as the insurer terms cannot or will not match trustees' approach to setting factors in the past. Typically this results in an improvement in tax-free cash at retirement, but not always and transfer values can sometimes be reduced. Trustees will want to think about this area and how to communicate it to members.

TRUSTEE PROTECTION

Once all the details for benefits and processes are nailed down and everything has been costed, trustees will start to think about their position. Trustees will want to ensure that they achieve an appropriate level of discharge of the fund's liabilities and have an indemnity from the sponsor or insurance in some form to protect against any additional costs unexpectedly emerging after the wind-up has been completed.

GETTING IT RIGHT IN THE BULK ANNUITY

Bulk annuity buy-ins have been covered widely in pension industry publications before. To complete a buy-out successfully though, there is a lot of additional thinking, planning and work to do. Funds may insure their liabilities in one or many steps. Either way it will be important to ensure that their bulk annuity transactions take account of what needs to happen not just in the period up to the transaction but also in the period up to issuance.

GUY FREEMAN
Rothesay Life

Guy was previously co-head of business development, having been at Rothesay Life since it started up in 2007. He has played a leading role in many of the insurer's transactions with pension funds, including those at Uniq, GM, Vestey, Lehman, CAA, the Post Office, Toshiba and Allied Domecq amongst many others and now uses his experience to support the business development team.

MALLOWSTREET
IN PARTNERSHIP WITH ROTHESAY LIFE
Pension Risk Transfer Report

60%

of schemes are checking the validity and accuracy of member benefits

within your reach

BEWARE BENEFIT GREMLINS – MAKING SURE THE BENEFITS ARE RIGHT

As a trustee, you've invested well and buy-out pricing looks within your reach. As you reach this stage, if you haven't already taken the time to review the benefits payable under your scheme, now is the time to start.

Within your reach

BEWARE BENEFIT GREMLINS – MAKING SURE THE BENEFITS ARE RIGHT

GETTING THE BENEFITS RIGHT – WHY DOES IT MATTER?

Trustees have a fundamental legal duty to ensure their beneficiaries receive the correct benefits. Even in the most well run schemes, deciding what these are can take time and be far from straightforward, with many skeletons potentially lurking in the closet; administrative practice may have diverged from scheme rules over time, scheme rules may be frustratingly opaque, communications with members about their benefits may be inconsistent with scheme rules, and, in the case of some long-running schemes, some historical documents may be missing altogether. Put those ingredients together and it's clear that deciding what benefits to insure can be a lot more complicated than just repeating whatever the latest scheme rules say.

But getting this right (and getting this right early) is about much more than trustee duties to members. Investing time at the beginning of the process will pay off in the long run. Not only does it reduce the risk of nasty – and potentially costly – surprises further down the line if benefits need to be adjusted (which in extreme cases could threaten the viability of the transaction) but going through an early exercise to check and confirm benefits will demonstrate that trustees are serious about transacting. This will help trustees get the engagement of insurers and access to competitive pricing and terms. It will also significantly reduce the risk of having to make material benefit changes as part of a post transaction data cleanse process, which could trigger insurer pricing adjustment clauses.

Trustees can consider securing residual risks cover on buy-out, to guard against the risk of errors in the data or benefits. However, this does not mean trustees can ignore any gremlins. Insurers will carry out detailed due diligence before taking on residual risks cover. Far better for trustees themselves to have identified, investigated and determined how to deal with benefit issues (with the advantages of time and advice) than be forced to resolve issues under the restrictions of a deal timetable, and where there could be pressure to go with the most "member-friendly" (and expensive) resolution to get the deal done.

MALLOWSTREET
IN PARTNERSHIP WITH ROTHESAY LIFE
Pension Risk Transfer Report

49%
of schemes have completed GMP reconciliation

> "For trustees targeting buy-out in the short to medium term who have not yet begun to focus on benefits, the action is clear: get started."

TROUBLE-SHOOTING BENEFITS – WHAT SHOULD TRUSTEES LOOK OUT FOR?

No two pension schemes are the same, but there are some common themes that come up again and again when looking at the issues that can cause delay and unexpected additional costs for schemes approaching buy-out:

- **Mergers:** It is not unusual for large, long-running schemes to have completed multiple mergers spanning many years. However, the benefits payable in respect of transferring members are not always clearly documented. Paperwork prepared in connection with the merger might cross refer to other documents that cannot be located. The task for trustees will be to decide what benefit should be secured for those members based on the limited information available.
- **Historical leavers:** Benefits will typically be governed by the rules in force at the date a member left service. Where scheme rules have been amended over time, the historical rules that apply to those members will need to be located and reviewed.
- **Special benefits:** As well as the benefits set out in scheme rules, additional or special benefits might also be documented elsewhere, including in individual member letters or augmentations agreed with the sponsoring employer. Where special benefits have been granted, trustees must ensure that all instances of those benefits are identified and reflected in the benefits an insurer is asked to price.
- **Revaluation, indexation and contracting-out requirements:** Careful attention should be paid to these, which produce benefit gremlins on a regular basis. Particular risk areas are where existing scheme rules have been amended (either badly, ineffectively or not at all) to cater for overriding statutory requirements. Pro-rating provisions for first year increases (including for spouse's pensions) can also be problematic. And don't even get us started on anti-franking tests. Scheme rules should be reviewed alongside administrative practice to decide whether corrective action is needed.
- **Equalisation:** Last, but by no means least, no list of this kind would be complete without mention of equalisation. A significant number of schemes are taking action – or correcting actions taken in the past – to equalise post-16 May 1990 benefits. Schemes will also need to take steps to remove GMP-related inequalities. Historical exercises to equalise benefits should be reviewed carefully to ensure there is no hidden exposure and that effective steps were in fact taken to implement the intended equalisation measures.

PREPARING FOR BUY-OUT

For trustees targeting buy-out in the short to medium term who have not yet begun to focus on benefits, the action is clear: get started. The process of preparing an accurate benefit specification that can be submitted to insurers as part of the quotation process can take time and require input from other stakeholders, including sponsoring employers, advisers and even former trustees. The process may well throw up historical errors or areas of uncertainty that need to be worked through and resolved. Tackling those before coming to market will not only mean trustees are well-placed to get the best price from insurers, but will also help ensure that both trustees and employers have greater certainty about costs from day one and don't face an unexpected bill when benefit gremlins rear their heads once the buy-out process is under way.

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Travers Smith LLP

Susie is a Partner in the Pensions team at Travers Smith. Susie advises on a broad spectrum of pensions matters with a particular focus on risk management, regularly advising trustees and insurers on buy-in and buy-out transactions.

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Niamh is a Senior Associate in the Pensions team at Travers Smith. She is experienced in advising trustees, sponsors and insurers in connection with a wide range of risk management exercises.

SPONSOR considerations...

... AND THE IMPACT OF BUY-OUTS ON PENSIONS ACCOUNTING

As pension scheme funding levels have generally improved over recent years the need for significant additional funding from the corporate sponsor to achieve a full scheme buy-out has reduced for the best funded schemes. However, even when no additional contributions are expected to be required there are several reasons for sponsors to remain close to the transaction and have full visibility of all aspects of the process.

MALLOWSTREET
IN PARTNERSHIP WITH ROTHESAY LIFE
Pension Risk Transfer Report

42%

of schemes have agreed buy-out as their endgame with their sponsor

Sponsor considerations

AND THE IMPACT OF BUY-OUTS ON PENSIONS ACCOUNTING

CERTAINTY OF COST

"Over the period to achieving a buy-in the de-risked investment strategy may be monitored closely and a price-lock could be utilised with the chosen insurer."

In the period between the sponsor and trustees agreeing to seek a buy-out there is scope for significant price movements, for example driven by insurer appetite or general market movements. Scheme sponsors can find this uncertainty of their final cash obligation difficult to communicate to key stakeholders and to build into their business plans. Typically the sponsor will want to consider how this uncertainty can be reduced and managed, for example over the period to achieving a buy-in the de-risked investment strategy may be monitored closely and a price-lock could be utilised with the chosen insurer.

In the case of full scheme buy-outs many sponsors will want to ensure there is a clearly agreed budget for the transaction with the trustees that captures the "all in" costs to move from buy-in to buy-out and wind-up the scheme.

Finally, an additional consideration that has emerged over recent times is also managing potential surplus positions and how that surplus could be avoided in the first place, e.g. through the use of escrow accounts and other contingent contribution structures, or distributed between members and the sponsor at the point of buy-out.

VALUE FOR MONEY

"A governance structure that gives the sponsor visibility over the process and input into negotiations to gain comfort they are getting a fair price for their capital input is key."

When an additional sponsor contribution is required to achieve buy-out, the sponsor may find it difficult to accept that trustees still ultimately have control over the process and the final decision to purchase the annuity contract. In most instances the objectives of trustee and sponsor are broadly aligned. A governance structure that gives the sponsor visibility over the process and input into negotiations to gain comfort they are getting a fair price for their capital input is key to the considerations for many CFOs and corporate boards.

Similarly, the sponsor will want to ensure any ancillary insurance is fit for purpose. Whilst the buy-in contract will cover member benefits as defined by the benefit specification and reflect any changes identified within the data/benefit true-up, sponsors will continue to be concerned about how any unknown issues will be resolved as ultimately these costs will lie with the scheme/sponsor. Comfort is often taken by leading negotiations on risk coverage, fully considering the value for money of any indemnity cover against cost and having clarity on potential gaps in coverage.

WIDER BUSINESS IMPLICATIONS

Removing the pension scheme from the corporate balance sheet is usually seen as a positive from the sponsor point of view. However, companies are not always aware of the accounting implications of a full scheme buy-out and this needs to be understood at the outset of a project. In particular, how the difference between the cost of insuring scheme liabilities and the accounting value held on the balance sheet is recognised through the accounts.

The treatment applied within the financial reporting depends on the facts and circumstances of each case but there are some general principles that apply across the various accounting standards. Engagement with the sponsor's auditors is essential at the outset of the project to avoid any unintended consequences.

IFRS and UK GAAP

- If the buy-in is considered to automatically lead to a buy-out then settlement accounting could be applied, typically recognised as a loss within the profit and loss (P&L) account. Alternatively, any losses recognised could be recognised through the Other Comprehensive Income (OCI).
- Following a transaction, but prior to full discharge of liabilities, assets are usually set equal to liabilities which means the volatility of the pension scheme for financial reporting purposes would be removed.
- The precise treatment of any balancing premium will be considered on a case by case basis.

US GAAP

- Sponsors reporting under US GAAP potentially have wider P&L considerations as a feature of the standard is that Accumulated Other Comprehensive Income (AOCI) could be accelerated through the P&L upon settlement of the pension scheme. Sponsors that report under US GAAP or have a US parent reporting under this standard need to be aware and comfortable with the potential P&L outcome when considering buy-in/buy-out.

Although accounting implications can sometimes appear to be a blocker to sponsors supporting a buy-out, the risk and volatility reduction achieved is generally recognised as a priority. A sponsor can also work with its advisers to manage the messaging to its shareholders, investors and analysts to bridge the gap between accounting measures and the true risk reduction achieved through a buy-out.

The sponsor will ultimately need to have comfort on all the aspects outlined above and work closely with the trustees from the outset of the project until the point of eventual buy-out and wind-up of the pension scheme.

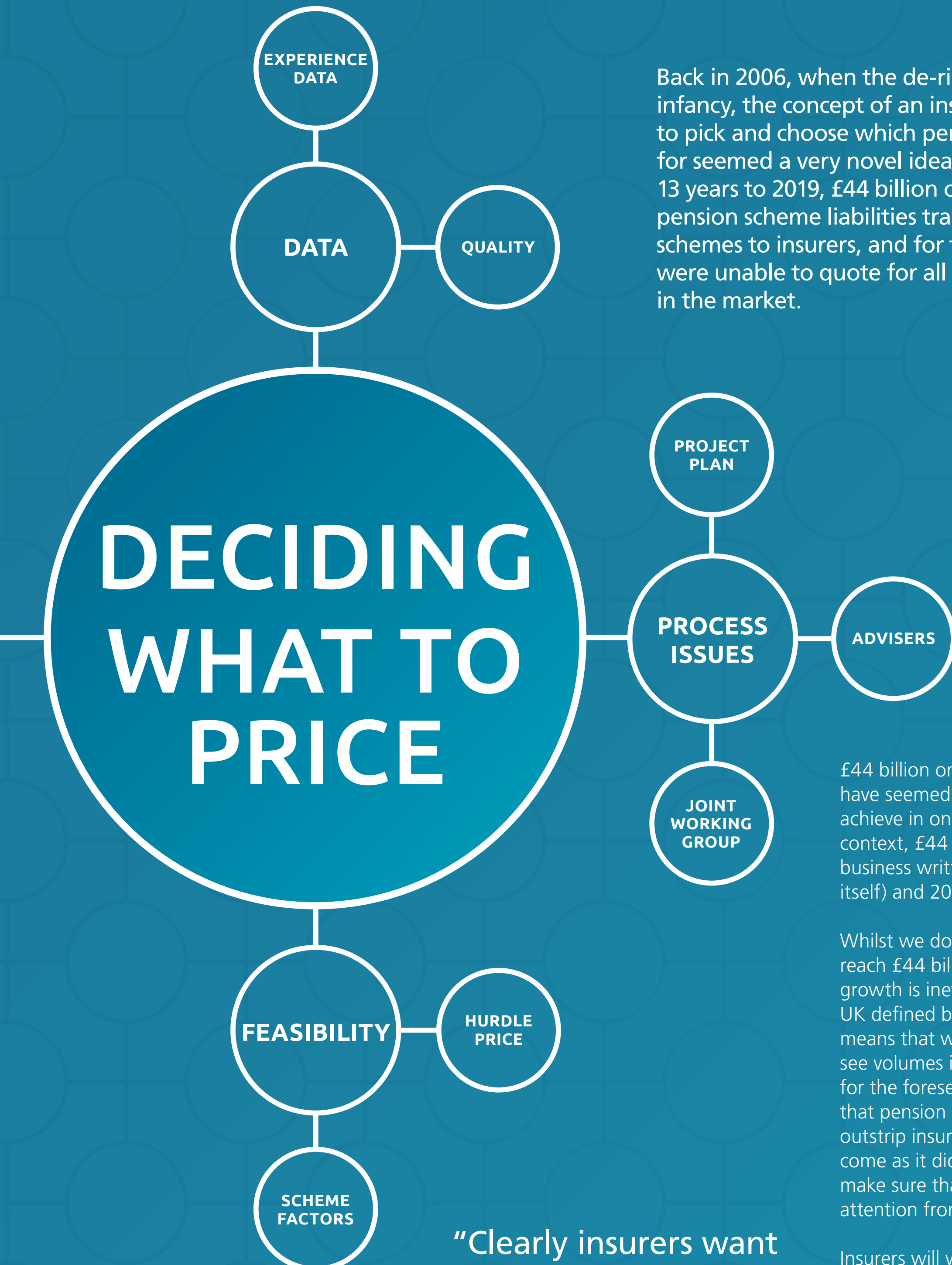
NIKHIL PATEL
PwC

Nikhil is joint head of Pension Risk Transfer and has over ten years' experience of working with trustees and sponsors on a range of buy-in/buy-out and longevity hedging projects, including transactions for the ITV Pension Scheme and the Airways Pension Scheme (BA).

MALLOWSTREET
IN PARTNERSHIP WITH ROTHESAY LIFE
Pension Risk Transfer Report

60%+
of schemes are aiming for buy-out in circumstances where the sponsor will receive any surplus

DECIDING WHAT TO PRICE



Back in 2006, when the de-risking market was in its infancy, the concept of an insurer having the luxury to pick and choose which pension schemes to quote for seemed a very novel idea indeed. Fast forward 13 years to 2019, £44 billion of defined benefit pension scheme liabilities transferred from pension schemes to insurers, and for the first time, insurers were unable to quote for all attractive opportunities in the market.

£44 billion only a few years ago would have seemed impossible for the market to achieve in one year. To put this into context, £44 billion is more than the total business written in 2018 (a record year in itself) and 2017 combined.

Whilst we do not expect the market to reach £44 billion in 2020, continued growth is inevitable and the size of the UK defined benefit pensions market means that we are forecast to consistently see volumes in excess of £30 billion a year for the foreseeable future. It is possible that pension scheme demand could outstrip insurer supply again in years to come as it did in 2019. So how do you make sure that your scheme receives attention from insurers in a busy market?

Insurers will want to work with as many schemes as possible, but at times working with all of them just isn't feasible due to restraints in the capacity of their people, reinsurance, capital and asset pipeline. Determining which pension scheme processes we can or can't work with is often referred to as "triage".

> "Clearly insurers want to work with as many schemes as possible but working with all of them just isn't feasible."

Working with your advisers, prior to coming to market, to understand how insurers "triage" and making sure you have prepared well will help you attract the highest number of bidders.
Each insurer will have its own key requirements such as preferred transaction size, the proportion of deferred liabilities they can accept and whether the scheme has transacted with a competing insurer in the past. There are however times where these filters alone are not enough to whittle down the opportunities to those which an insurer has capacity to work on. In these circumstances, insurers will start to focus on secondary issues to try to identify which processes have the highest likelihood of closing, and in particular, which are most likely too close with the given insurer.

There are three main areas we focus on when assessing the viability of a transaction and ticking as many of these boxes as possible will increase a schemes attractiveness in the market place.

1. PROCESS ISSUES

Is the deal supported by both trustee and company? Is there a joint working group in place? If the answer to either question is no, then the probability of the transaction closing quickly is greatly diminished, as the party not currently in-the-know will need to draw breath once they become aware of the proposed transaction and take their own advice before any proceeding further.

Appointing experienced advisers who are familiar with the bulk annuity market and who have good, open communication channels with all insurers is also really important. Often insurers like to know that the scheme is being guided by advisers who understand what is important to insurers and gives them the confidence that the process is likely to be well run and thought though.

2. FEASIBILITY

Is there a clear hurdle price or target in mind for a transaction? Are advisers able to articulate it, and share it with insurers? For insurers, the existence of a price hurdle demonstrates a clear understanding of the marketplace and also an articulation that a process will close. Transparency on the schemes budget for a transaction allows insurers to focus resource on processes where we believe a trade is viable. Early conversations with insurers will also avoid schemes incurring costs coming to market when it is highly unlikely any insurer will reach the hurdle price.

For a transaction involving deferred members, it is also important that trustees have considered their scheme factors and how these compare to the factors provided by insurers. This a critical piece of thinking which has caused a stumbling block for many schemes we have seen, and makes a huge difference to our assessment of a transactions likelihood of closing. Please see the article by David Ellis on page **38** for more details.

3. DATA

Trustees are usually advised to ensure their data is "in order" prior to coming to market, and we echo this guidance. Whilst it is unlikely that an insurer will refuse to quote because of a small number of data issues, they could be the factor that tips the balance between one transaction and another.

Are there clear gaps in the data, inconsistent data items, or a large number of queries being asked of the adviser? These sorts of issues suggest that the scheme may not have done the necessary preparation, and the data isn't of good enough quality for a transaction to occur. It is better to take your time to get this right before approaching the market, so that any issues can be identified and resolved in good time, and not rushed through in a busy quotation process.

Has the scheme collected sufficient experience data (showing changes in member status, such as deaths or transfers), and does it reflect the population included in the transaction? For instance, if a quotation is to cover all pensioners with a pension over £10,000 per annum, can we identify which members within the experience data are associated with pensions in excess of £10,000? Or if the quotation population represents one section of a scheme, does the experience data contain section codes to recognise each section? Quality experience data will allow us underwrite the longevity basis and solicit reinsurance quotes for the underlying longevity risk.

Has the scheme collected marital status information, such marital status of members and the dates of birth of any spouses and dependants? This data helps insurers manage their risk exposure and there are a number of reinsurers who load their quotes for prudence in the absence of this data. It is important to also be clear where this data has come from – was it collected for each member during employment or on retirement, or as a recent bulk write-out exercise? If information comes from multiple sources, then it is important to be able to distinguish between these in the data provided.

Insurers want to quote on as many processes as they can and will find it hard to turn down a well-prepared scheme that has met all of the points above. Preparing well and considering how an insurer will triage you scheme prior to coming to market will ensure the widest interest from the right insurers for your scheme.

SAMMY COOPER-SMITH
Rothesay Life

Sammy is head of Business Development at Rothesay Life and has been with Rothesay since 2011, working on transactions with the pension schemes of Asda, National Grid and telent, amongst others, plus the insurance transfers with Prudential, Aegon and Zurich.

Other considerations

Chapter 2

The impact on member options

PENSION COMMENCEMENT LUMP SUMS AND CASH EQUIVALENT TRANSFER VALUES

A buy-out is a major, irreversible decision for any trustee to make

While the trustee should, therefore, focus on areas such as the choice of insurer, the premium and the treatment of assets, it should also seek to ensure that individual members will be no worse off and ideally better off as a result of the deal where they take optional benefits. Two insurers could offer the same price but one might provide members with higher member options for that price.

Therefore, trustees should scrutinise conversion terms offered by insurers to understand the immediate and longer-term impacts on benefit levels for members who wish to take some or all of their benefits in an alternative form – a member option.

Pension commencement lump sums (PCLSs) and cash equivalent transfer values (CETVs) are two key options and affect many members.

To effect a buy-out, it is usual to go through a buy-in period first. This brings additional considerations because, in essence, the economics rest with the insurer during the buy-in period, but the legal responsibility remains with the trustee.

Let's consider CETVs first. A CETV should represent the best estimate of the capital cost of providing a member's benefits in the scheme. During a buy-in period, the Scheme Actuary should advise the trustee on whether the CETV basis remains appropriate given the significant change in investment strategy. There are a number of reasons why the insurer's and Scheme Actuary's best estimate calculations could differ.

For example, the scheme's CETV basis and the insurer's equivalent individual surrender value basis might be updated at different frequencies; the insurer might have different return expectations for its annuity book to the scheme's assumption and the insurer and scheme could have different best estimate inflation and mortality expectations.

The scheme could, therefore, receive a higher or lower surrender value from the insurer than the trustee would have paid to the member as a CETV before the buy-in period. Is the trustee happy to pass on the surrender value received without amendment? Many trustees and their Scheme Actuaries conclude that adopting the insurer's surrender values as the CETVs during the buy-in period is reasonable, which also has the advantage of stability once the buy-in is converted into a buy-out. Other trustees decide to top-up to their chosen CETV amounts, utilising scheme funds or further contributions from the sponsor, during the buy-in period where the insurer's surrender values are lower.

Where necessary, it is possible in some circumstances to pay an insurer at the outset of the buy-in to boost the amount of surrender values payable during the buy-in period and even thereafter, during the buy-out period.

The scenario for PCLS is slightly different. The amount of residual pension a member can take at retirement, after taking a tax-free cash sum, is determined by the in-force commutation factors.

Given administrative burdens of regularly updating commutation factors and the desire for a simple set of factors that are easily communicated to members, pension scheme factors tend to be fixed for several years at a time. Insurers, however, regularly update their own commutation factors and these are typically more generous to members than those offered by pension schemes.

> "Insurers, regularly update their own commutation factors and these are typically more generous to members than those offered by pension schemes."

As part of the bulk annuity negotiations it is possible for a trustee to ask insurers to reduce their commutation factors by a fixed proportion (insurers typically put a cap of 20% to 25% on the reduction and are unlikely to go below the current scheme factors) in return for a lower premium. This allows insurers to keep their factors compliant with Solvency II and the Treating Customers Fairly regime, members are offered generally more generous commutation factors during the buy-in and buy-out periods and the bulk annuity deal becomes more affordable for the trustee.

Trustees should also consider how comfortable they are switching from fixed scheme commutation factors to variable insurer factors. Trustees could be concerned that a sharp rise in yields could lead to members receiving lower residual pensions in the future than they would using the existing scheme factors.

It is clear that the generosity of member option factors affects the amount of benefits members receive. It is worthwhile therefore, to focus on how the insurer's factors compare to the scheme's and what treatment should be put in place during the buy-in period and once a buy-out has been implemented.

David is a Partner in Mercer's Risk Transfer group, specialising in bulk annuity advisory for trustees and corporates.

DAVID ELLIS
Mercer

MALLOWSTREET
IN PARTNERSHIP WITH ROTHESAY LIFE
Pension Risk Transfer Report

36%

of schemes completed a liability management exercise in 2019

> "Insurers and reinsurers will be concerned about selection risk associated with liability management exercises which again may increase the premium payable."

MEMBER OPTION EXERCISES

The focus for many schemes as their funding levels improve is to research all avenues which may help bridge the gap between scheme assets and an insurance premium to fully settle the scheme liabilities.

Liability management exercises are often the first options considered. These can be transfer value or winding up lump sum exercises where the relevant liability is discharged at a value less than the premium otherwise payable. Alternatively benefits may be reshaped through a pension increase exercise or simplifications may be applied to certain benefit entitlements which are more cost effective to insure.

A number of different factors will be considered in deciding which of these options to pursue. A trustee will likely consider each of the following points when deciding whether to run a transfer value exercise:

1. Could this exercise bridge the gap to buy-out? Scheme transfer values are generally lower than the premium payable to fully secure that liability. Therefore even modest take-up levels could improve scheme funding levels.
2. Are transfer values offered by the scheme at a higher level than those provided by an insurer? In that case, trustees may take the view that members should have one last chance to transfer on better terms.
3. Is there a lost opportunity cost to the scheme? If a member transfers out shortly after buy-out, has the scheme lost some value by paying across a premium amount greater than the transfer amount settled to that person?

While these are all important and may seem to release value to the member or the scheme, it is worth considering the possible offsetting implications on any insurance premium payable.

1. Many insurers already allow for future transfer take-up in the premium quoted. The premium will increase if the assumption for future take-up is reduced which is likely after an exercise has been run. Many insurers derive their take-up assumptions based on past experience on their book (in a similar way to assumptions for pension commencement lump sums).
2. Insurers and reinsurers will be concerned about selection risk associated liability management exercises which again may increase the premium payable. The key selection risks are ill health and marital status. For example, most transfers do not take into account a member's actual marital status and will instead use a standard assumption of say 80% married. This means that any member who is single is able to realise value for a benefit they were never actually going to receive. In fact we have seen instances where communications to members have almost encouraged this anti-selection behaviour.

Trustees may also consider reshaping the benefit obligations payable to a form that is more cost effective to insure, for example where a number of pension increase underpins exist which are expensive in the insurance market, or to release value to the scheme. Pension increase exchange (PIE) exercises have become much more common for these reasons. Under a PIE offer, a member may be offered a higher non-increasing pension in exchange for their current increasing pension. This may be run as a one-off exercise or schemes may offer this option as a matter of course to members at retirement.

While as an insurer we are still exposed to anti-selection behaviour as a result of these exercises, this is generally much less pronounced than in a transfer value exercise. This is because the value of the uplift is paid over time whereas for a transfer value, the member receives the full value of their benefit upfront. In order for an individual to choose whether or not to convert their pension increases on health grounds, they need to have a longer-term view on their life expectancy which is much more difficult.

As such we are happy to work with schemes who want to implement a PIE either before entering a bulk annuity which may create a saving, or after, potentially resulting in a refund. However not all market participants will take the same approach and discussing this intention early will help trustees identify the right insurer early in the process.

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Rothesay Life

Pamela is Co-Head of Pricing and Reinsurance. Pamela joined Rothesay in 2009 and is responsible for underwriting of new liability transactions. Pamela has been directly involved in most of Rothesay's liability transactions to date. Prior to joining Rothesay, Pamela was at Willis Towers Watson in London and San Francisco. Pamela is a pensions actuary and a Fellow of the Institute of Actuaries.

MALLOWSTREET
IN PARTNERSHIP WITH ROTHESAY LIFE
Pension Risk Transfer Report

38%

of schemes have not considered whether their illiquid assets can be transferred in specie to an insurer

Your asset strategy is an integral part of your journey toward buy-in or buy-out. When setting your sights on an insurer transaction, there are three key areas to consider in relation to your asset portfolio:
– **price hedging;**
– **liquidity; and**
– **strategic fit.**

Lining up your assets

1: PRICE HEDGING

You should start thinking about this as soon as you have established an insurance solution as your eventual funding goal. This could be years before the actual transaction. The aim is to develop an asset strategy that is managed specifically against the future cost of buy-out, to minimise pricing risk and stabilise your journey as far as possible.

The key point to note is that, other than liability risks (inflation and interest rates), the only "hedgeable" market parameter that drives insurer pricing is credit spread movements: as spreads widen, pricing improves and vice versa. If your objective is an insurance solution, a credit-based portfolio might help reduce volatility against the future price of the buy-out.

This also means that, at the point of transaction, your portfolio is naturally aligned with the price-lock insurers are willing to write, as well as the assets they might consider taking as premium payment.

2: LIQUIDITY

As you enter the stage of being ready to transact, your aim should be to maximise your flexibility and negotiation power. In this context liquidity is king: for a full buy-out, you need to have an asset portfolio that is fully realisable in markets within a short time period. Some insurers may be able to work with you to accommodate illiquid assets, but this may be a path you cannot rely on.

While insurers may be willing to take some (or all) of your assets as part of the premium payment, the views on this will vary from insurer to insurer and transaction to transaction. In most cases insurers are unlikely to consider assets beyond cash, gilts and corporate bonds, and often they may want cash or gilts only.
Even if one insurer is willing to take a given illiquid asset that is "insurer friendly", other insurers would not take it as it does not fit with their particular requirements or constraints. Your choice of insurer should be driven by who will give you the best deal, and not by who is willing to take a given asset.

This does not mean that you need to start selling all your illiquid assets as soon as you decide to undertake a transaction. However, it does mean that you should start contingency planning for how and when you will dispose of any illiquids as early as possible in the process, ideally 6-12 months before execution. The aim here is to give yourself options to maximise flexibility and control.

3: STRATEGIC FIT

For partial buy-ins, consider the interaction with your wider asset allocation, journey plan and objectives/constraints like you would with any other asset purchase. Strategic fit can be assessed by considering the following:

- **Impact on your portfolio returns:** If you are using leverage to achieve your liability hedge, a partial buy-in may well require a sale of growth assets to retain the same hedging, which will extend your journey to full funding unless the sponsor contributes more cash.
- **Trade-off against other risks:** Extending your timescale could increase your covenant risk, so how does that stack up against the longevity risk reduction you get from the buy-in?
- **Bigger fish to fry:** You should also consider how dominant longevity risk is compared to your other remaining risks. Say if you are still running meaningful levels of growth asset risk, it is often more efficient to tackle this before longevity risk.
- **Flexibility:** A partial buy-in will reduce overall liquidity and your ability to dig your way out of a future deterioration in your funding position. Stress testing and contingency planning are an important part of the decision-making process: would the sponsor plug a future gap with further contributions, and/or would the trustees accept a longer time horizon?

A programme of partial buy-ins over time can be a good way to reduce risk over time, but you need to have thought through the strategic implications of such a strategy in order go to market with a high degree of confidence and credibility.

METTE HANSEN
Redington

Mette is a Director in Redington's investment consulting team, where she helps UK pension schemes with their investment and strategy related challenges. She has spent the last decade working in a variety of consulting roles in the industry, and she is a CFA charterholder.

RESIDUAL RISK COVER

What flavours of cover are available under your bulk purchase annuity policy?

A bulk purchase annuity (BPA) is an insurance contract purchased by trustees of an occupational pension scheme. It provides insurance in respect of pension and lump sum benefits payable from the scheme that are set out in a data file and benefit specification incorporated into the contract.

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Pension Risk Transfer Report

nearly

60%

of schemes aiming for buy-out are considering residual risk cover

Residual risk cover

All BPAs provide vanilla cover. This means that the insurer assumes the longevity and investment risk associated with providing specified benefits to specified beneficiaries. A BPA that only provides vanilla cover is called a "vanilla BPA" and most BPAs in the market are vanilla BPAs.

Where trustees purchase a vanilla BPA, the risk that the trustees have not secured benefits that correctly match the entitlements of some or all beneficiaries under the scheme (and any additional liability resulting from this) remains with the trustees (and, ultimately, the scheme sponsor). The trustees may ask the insurer to amend the insured benefits in exchange for the payment of an additional premium, but the opportunities for trustees to do so are usually limited.

Consequently, when a scheme is planning to wind-up, trustees (and their sponsors) often consider the options available to them for removing the residual risks that would otherwise remain with the scheme.

One option is to purchase "residual risk cover" from a bulk annuity insurer. Residual risk cover will not provide protection against all risks that might result in a liability being left with the scheme (and its sponsor) following the winding up of the scheme.

A "residual risk BPA" will include detailed provisions describing the circumstances in which the insurer will, and, importantly, will not, pay benefits greater than the insured benefits.

It is important that trustees (and their sponsors) understand that the additional "flavours" of cover available from bulk annuity insurers and their limitations before they decide whether or not they want to request something more than vanilla cover.

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Pension Risk Transfer Report

60%
of schemes are cross-checking administrator practice with the scheme rules

WHAT FLAVOURS CAN BE ADDED TO THE VANILLA COVER?

Broadly speaking, the principle underlying residual risk cover is: if a beneficiary can prove an entitlement to benefits that are different to insured benefits as a result of a risk covered by the residual risk cover, the insurer will adjust the insured benefits.

The risks that bulk annuity insurers will offer to cover as part of their residual risk cover typically include the following:

- **"Data risk cover"** – The obligation for the insurer to adjust the insured benefits (and meet any additional liability) due to errors in the insured data set.
- **"Legal risk cover"** – The obligation for the insurer to pay a beneficiary's correct benefit entitlement if the insured benefits are understated due to a legal issue, such as the incorrect administration of the scheme due to a misunderstanding of the benefit promise under the scheme rules or a past failure to implement legal requirements.
- **"Missing beneficiaries cover"** – The obligation for the insurer to pay benefits to an individual who can prove an entitlement to benefits under the scheme who was not in the insured data.

DECIDING WHAT'S RIGHT FOR YOUR SCHEME

Whether to request residual risk cover and, if so, the exact scope of that cover will be down to the trustees' particular tastes; the insurer's appetite to provide the cover for the size of the scheme; the cost of such cover; the insurer's willingness to let trustees cherry pick specific elements of cover; and contractual negotiations.

There are certain key issues that trustees must consider when deciding the right flavour for their scheme.

TIMING OF INCEPTION

Are the trustees looking to purchase a BPA with residual risk cover that incepts on day 1, or immediately before buy-out (i.e. the point at which the insurer issues individual policies to the insured beneficiaries following a request from the trustees prior to the completion of the wind-up of the scheme)?

If the trustees require the flexibility to carry out a data cleanse following inception, the insurer may propose to assume residual risk once all cleansing is complete. An alternative is for the trustees and the insurer to agree specific cleanse items and price them in advance. However, insurers might be concerned that, when carrying out agreed cleanse items, trustees find additional issues that result in increases to benefits, which are not (and do not get) reflected in the premium.

SCOPE OF COVER

Each bulk annuity insurer will have its own standard carve-outs from residual risk cover which are, in most instances, non-negotiable. They also have well established due diligence processes to assess the risk they are assuming: serious data errors and undisclosed legal issues will likely be discovered before the trade takes place and liabilities relating to such errors/issues will be excluded from the cover provided under the BPA unless the trustees correct them.

Cover for errors in the execution of legal documentation is one example of an area that might be carved out. This is a complex area and, as a result, the scope of such cover often requires significant negotiation and the insurer will often identify errors during pre-trade due diligence which the trustees will effectively be forced to correct before they can transact. Consequently, our experience is that pragmatism often prevails and trustees seek to obtain protection for this risk from elsewhere (e.g. an indemnity from the sponsoring employer and/or from the general insurance market).

CONCLUSION

The recipe for success for trustees is:

1. Decide in advance what type of insurance cover they want.

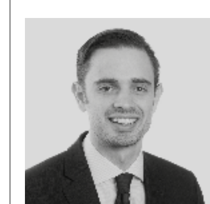
The market is crowded and trustees need to compete for insurer bandwidth by making themselves attractive potential counterparties.

2. Conduct an exercise to identify data/legal issues and fix them (or at least flag them in a way that enables insurers to adjust their premium accordingly).

Make it as easy as possible for the insurer to assess the risks – carry out data cleansing actions and detailed legal due diligence to identify and fix any issues before going to market and make any reports available to the insurers during the quotation phase.

3. Put in place a suitably experienced advisory team.

The roles of the buy-out consultant and the legal adviser are critical to a successful trade. The interests of a scheme are best served if these advisers have good experience of bulk annuity transactions; particularly residual risk trades. This will ensure that trustees receive advice underpinned by a clear understanding of what is achievable within the market and how best to achieve it. Trustees should, therefore, consider whether their usual adviser team is best placed to advise them on a bulk annuity transaction or whether a specialist advisory team should be brought in for the purpose.



Stephen is a risk transfer specialist. He has advised insurers and trustees on residual risk transactions relating to c.£25bn of liabilities; including advising Rothesay Life on its £4.7bn transaction with telent.

STEPHEN LONGFELLOW
Gowling WLG

The emergence of consolidators

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Pension Risk Transfer Report

2%

of schemes are targeting DB consolidation

Not every scheme's journey can or will end with a buy-out – whether because of lack of sponsor support, market appetite or just the funds to get it done. The recent emergence of "DB superfunds" has therefore created another option for trustees and sponsors, whilst also presenting a conundrum for insurers.

Emergence of consolidators

To illustrate this, let's start by putting ourselves in the shoes of a trustee board or sponsor looking to secure their scheme.

The key question is: how do you assess whether insurance or a superfund option is the right solution for you and your scheme members?

The three key principles that trustees and sponsors should be able to answer before proceeding with a superfund are:

1. ARE YOU UNABLE TO AFFORD FULL BUY-OUT TODAY?
2. IS A FULL BUY-OUT IN FIVE YEARS UNREALISTIC?
3. IS A SUPERFUND TRANSACTION LIKELY TO IMPROVE OUTCOMES FOR YOUR SCHEME MEMBERS?

To start with, you need to get to grips with what is possible. Can you actually afford either option and would the Pensions Regulator (TPR) grant clearance if you pursued consolidation?

In June 2020, the Pensions Regulator published an interim framework for the regulation of superfunds. The framework didn't provide much information on the requirements for trustees considering a transfer to a superfund, but it did suggest preventing schemes that can buy-out now or within the foreseeable future (e.g. five years) from transferring. Whilst it is currently unclear what requirements will be included in the final legislation (and in TPR's guidance to trustees), in cases I am working on with trustees, their thinking has naturally looked to consider three questions (originally referred to as gateway tests in the 2018 consultation). This remains, in my view, the best place to start when considering whether consolidation or insurance is right for you and your scheme members.

In simple terms, if there is a realistic prospect of buying out soon, then schemes and sponsors should not be prioritising a transfer into a superfund. As secure as superfunds will need to be to meet TPR's interim framework and authorisation, there is no denying that insurance is the security gold standard. There needs to be a greater acknowledgement that, although superfunds aim to improve member security when compared to the covenant of the sponsor, they will not provide the same level of guarantee as an insurer.

If you can't afford to insure your scheme in the near future, the question then becomes: how do you judge whether you have a realistic prospect of buying out in the medium term, and how do you explore your options? If the scheme sponsor is more willing to fund one solution over another, the assessment gets even trickier. This is where the dilemma for insurers begins.

As we all know, there is a big difference between a "standard" insurance quote and the kind of price you might achieve with an insurer who is pulling out all the stops to win your business. In fact, this difference can easily be large enough to completely alter a trustee's analysis of which path to take.

Insurers are asked to quote on far more transactions than they could ever feasibly complete, so they have to be savvy about who they spend their time working with. If a scheme isn't fully committed to insuring, there's a good chance the insurers will be able to tell, and are therefore less likely to provide a competitive price. They may not bid at all. The onus therefore falls back on the adviser to assess what might be realistically achievable pricing. Transaction experience will be key.

The dynamics for insurers are interesting. If they know a scheme could ultimately end up transferring to a superfund, is it a good investment of time and work to produce a best and final quote? Then again, by not providing a competitive quote, are they just facilitating superfund transactions by making insurance appear unattainable and essentially "giving" the business away?

It is also difficult for insurers to predict superfund pricing as the market is in its early stages. I have seen superfunds willing to offer very attractive pricing in order to win early cases and hit the ground running.

This isn't a purely academic thought experiment – insurers I speak to are dealing with this exact puzzle already.

The take-away for trustees and sponsors is this; if you want to get the right outcome for a scheme at the best price, you need to take specialist advice on how each route might play out covering key questions such as: what realistic pricing might be; how TPR might react; how strong is your sponsor covenant; and how volatile is the range of possible outcomes for your scheme.

Key to getting the best out of both insurers and superfunds will be to commit to one option as early as possible. This might require proactive decision making, possibly on incomplete information, which isn't easy. However, this will be essential in achieving full engagement and better pricing from either the insurer or superfund. It is therefore more important than ever that you work with an adviser who can give you clear insight into both markets before you dive into the process.

Key differences between superfunds and insurance

	SUPERFUNDS	INSURANCE
Governance	Superfund directors and trustees	Company directors
Safety net	PPF	FSCS
Regulated/monitored by	TPR	PRA and FCA
Capital requirements	Low risk Technical Provision basis plus additional capital equal to 1-in-100 risk over 5 years and a longevity reserve	Low risk Technical Provision basis plus additional capital equal to 1-in-200 risk over 1 year and a Risk Margin
Overall capital comparison	Overall we estimate that insurers might hold around twice as much risk capital as a superfund on a like-for-like basis for a given liability, however this is very dependent on the nature of the liability and other risk mitigation measures being taken (e.g. reinsurance etc).	

Whilst these are difficult decisions, ultimately they are about providing the best solution for your members.

Rachel specialises in superfund solutions as part of Isio's Pensions Risk Settlement team. Previously she worked at the Pension SuperFund helping to develop the proposition.

RACHEL BRADSHAW
Isio

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IN PARTNERSHIP WITH ROTHESAY LIFE
Pension Risk Transfer Report

34%

of schemes are planning to de-risk by hedging via a longevity swap or similar

Convert or novate

CONVERTING A LONGEVITY SWAP

Just over ten years on from the completion of the first longevity swaps we are now seeing an increasing trend of pension schemes looking to convert – or novate – existing longevity swaps to buy-ins, for example recent transactions by MNOPF and Rolls-Royce. This reflects the fact that schemes' funding levels have improved in the intervening period, allowing them to further de-risk and transfer investment risk to the insurance market, in addition to the longevity risk protection they already have in place.

Convert or novate

CONVERTING A LONGEVITY SWAP

HOW DOES A NOVATION WORK?

Longevity swaps are generally structured as a contract of insurance, between the pension scheme and an insurance intermediary, and then an onward contract of reinsurance, between the intermediary and a reinsurer. The pension scheme pays a fixed stream of payments to the intermediary, who pays these on to the reinsurer – and in return payments are received based on the actual life span of the covered membership – **see Figure 1**. There isn't an upfront payment and the scheme continues to have the flexibility to invest its assets to generate return – and therefore retains investment risk.

If, in the future, the scheme wishes to undertake a buy-in for the population covered by the longevity swap, the longevity insurance contract is cancelled, and the ownership of the reinsurance is novated from the intermediary to the buy-in insurer. In exchange for an upfront premium, the buy-in insurer also takes on the investment risk associated with the longevity swap portfolio, and each month pays the scheme the pension payments needed to pay the pensioners – **see Figure 2**.

The key reason novations are possible is that most buy-in insurers hedge almost all of their longevity risk using longevity reinsurance. They use the same reinsurers and similar contractual arrangements to pension scheme longevity swaps. Therefore the buy-in insurer will be happy to take on the existing longevity swap – in fact the pension scheme has already completed part of its job for it.

FIGURE 1

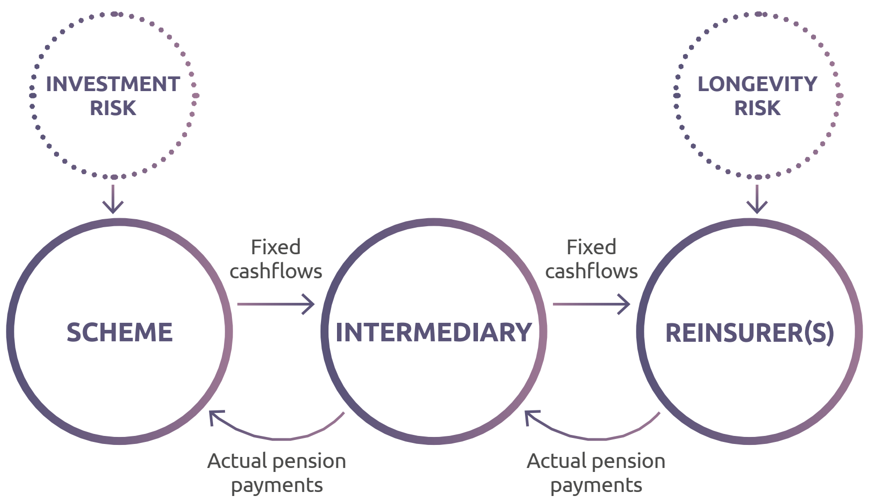
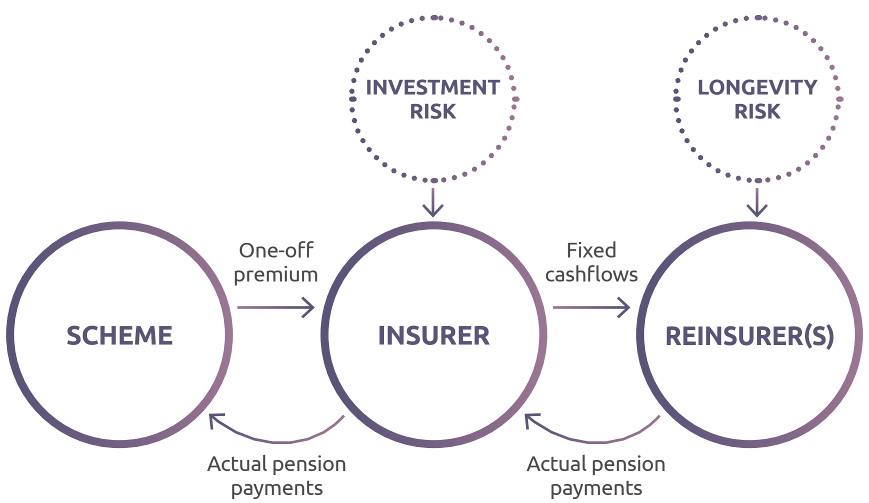


FIGURE 2



WHAT ARE THE BENEFITS OF BEING ABLE TO NOVATE A LONGEVITY SWAP?

In addition to the historical longevity risk protection provided by the longevity swap, the key benefit is that as the buy-in provider is only pricing investment risk – not longevity risk – the price of the buy-in/buy-out is significantly more attractive. In addition, because the buy-in insurer doesn't need to go out and procure longevity reinsurance, the buy-in can potentially be completed quicker than a standard buy-in, allowing the pension scheme to rapidly lock into market conditions that lead to advantageous buy-in pricing.

> "The key reason novations are possible is that most buy-in insurers hedge almost all of their longevity risk using longevity reinsurance."

WHAT ARE THE KEY CHALLENGES WHEN NOVATING A LONGEVITY SWAP?

There are several potential challenges. Firstly, the cooperation of the reinsurer and the intermediary are needed to enable the novation. However, it should be possible to navigate this as the original longevity swap contract will contain legal obligations on these parties to cooperate. Using a captive cell owned by the trustee, or an insurer not active in the buy-in market, as the intermediary should help to ensure their full cooperation.

There is also the possibility that the preferred buy-in provider does not find the longevity swap attractive – for example because of a particular contractual term in the original longevity swap contract or because they already have significant counterparty exposure to the reinsurer and do not wish to have another longevity swap with them. This can be largely mitigated by:

1) ensuring that when the longevity swap is agreed, it is future-proofed by being buy-in provider "friendly"; and
2) by sharing all of the information on the longevity swap with the buy-in market at the very start of the buy-in quotation process.

It's also worth noting that some of the early longevity swaps had complex constructions, due to the requirements of the intermediaries at the time. This included use of multiple reinsurers and the intermediary retaining some of the longevity risk. This doesn't mean these longevity swaps can't be novated, but sufficient time should be allowed in the buy-in project to navigate the complexity.

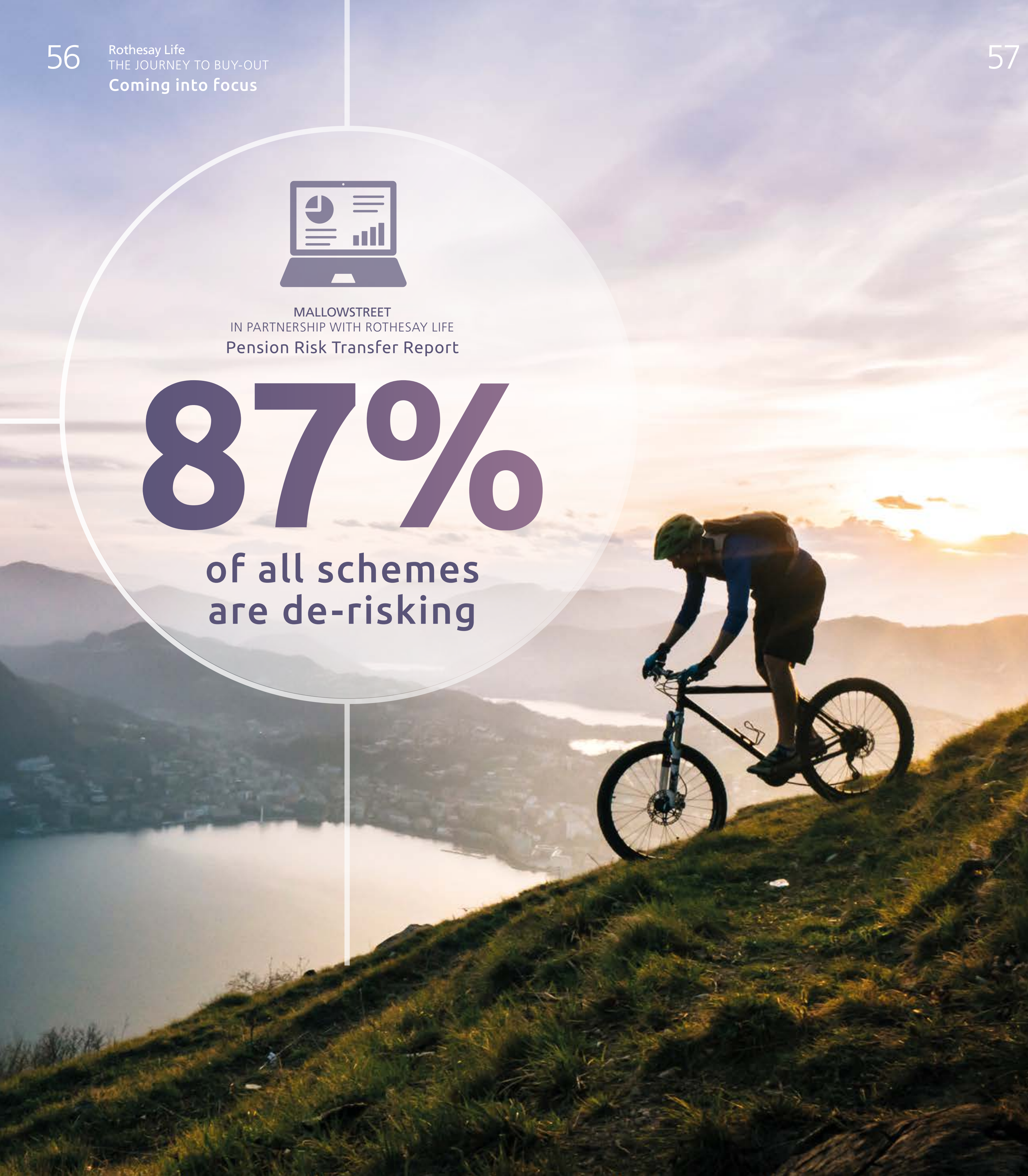
IN SUMMARY…

The novation of a longevity swap to a buy-in is now tried and tested. Longevity swaps allow pension schemes to manage longevity risk today whilst retaining investment freedom, and the ease of novation means they are a great stepping stone to a future buy-in.

Further, whether your chosen insurer for the swap conversion has experience of converting longevity swaps or not the underlying reinsurer will almost certainly have experience, either through past swap conversions or through the novation of longevity reinsurance contracts as a result of back book annuity transfers (the process whereby one insurer sells a block of annuities to another insurer).

SHELLY BEARD
Willis Towers Watson

Shelly is a Senior Director within Willis Towers Watson's Transactions Team. Her recent projects include leading the novation of a longevity swap to a buy-in for the MNOPF and advising HSBC on their longevity swaps.



MALLOWSTREET
IN PARTNERSHIP WITH ROTHESAY LIFE
Pension Risk Transfer Report

87%

of all schemes are de-risking

Longevity and reinsurance appetite

Although death is often quoted as one of life's only certainties, the timing is rarely predictable. Managing this uncertainty is a key element of protecting the safety of people's pension.

This "longevity risk"

is one that plan sponsors and trustees are already familiar with – especially in the current low interest rate environment. For most annuity purchase transactions, some longevity risk is transferred to a reinsurer rather than being fully held by the direct insurer.

Longevity and reinsurance appetite

HOW LONGEVITY RISK IS TRANSFERRED?

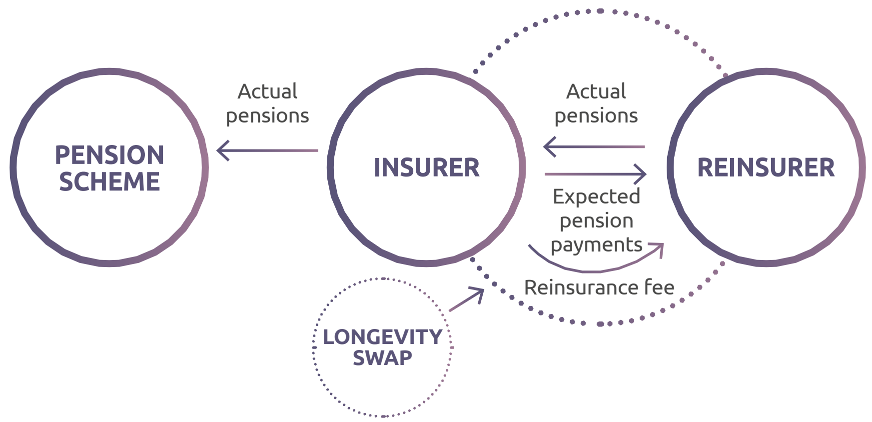
By far the most common structure uses a bespoke agreement known as a longevity swap which defines payments between the insurer and reinsurer. These payments work as illustrated in the diagram opposite:

The insurer receives a series of payments that are determined by the actual pensions they pay out. In return, they commit to pay the reinsurer a set of fixed payments that are equal to the expected pension payments at the time of the reinsurance deal, together with a fee payable to the reinsurer. In the unlikely event that people live exactly as long as expected, the only payment exchanged would be the reinsurance fee.

After putting in place a longevity swap, the insurer still needs to invest assets so they can meet the payments to the reinsurer. However, the insurer no longer needs to take the risk that pension payments are higher than expected because people live longer than originally assumed.

TRANSACTION PROCESS FOR LONGEVITY SWAPS

For all but the largest annuity purchase transactions, the process of implementing a longevity swap will be invisible from the perspective of trustees and sponsors.



For smaller transactions (less than £300m), there is sometimes a preferred reinsurer from which the insurer has received guaranteed pricing for future transactions. Alternatively, the insurer may retain longevity risk or bundle together several smaller transactions before approaching the reinsurance market.

For larger transactions, reinsurers are increasingly being asked to provide longevity terms at the same time as the quotation process. This is especially true where schemes have a reasonable level of mortality experience data that can be used to set longevity assumptions, and this can take up to eight weeks to price. Cleansed and complete data allow for quicker quote turnaround and a higher likelihood of having the transaction prioritised in a busy market. From an end-to-end perspective, the longevity transaction has similar steps to an annuity purchase process – future payments need to be priced up, a reasonable fee is determined through a competitive process, internal reviews and approvals are obtained and a reinsurance contract is negotiated.

WHY DO INSURERS TRANSFER LONGEVITY RISK?

This additional work to transfer longevity risk has a number of significant benefits for insurers under the UK regulatory regime:

- Many are already holding significant longevity risk from earlier transactions and individual annuity portfolios will want to ensure this is balanced within their overall business
- It removes the need to hold capital to cover longevity risk (and replaces it with counter party capital) and alleviates some of the Risk Margin strain
- Ultimately it increases security for policyholders and shareholders

Many annuity purchase transactions involve some form of longevity reinsurance for these reasons. Some insurers will pass all longevity risk on immediately, others will be comfortable retaining elements of longevity risk where it provides diversification with other risks they are running in their business.

WHY DO REINSURERS HAVE APPETITE FOR LONGEVITY RISK?

Most reinsurers are governed by the same regulatory regime as insurers so it might seem surprising that taking longevity risk is attractive to them. The key difference for reinsurers is they can hold UK longevity risk alongside other risks written in domestic and overseas markets from both life and non-life reinsurance. This diversification provides a more capital-efficient home for longevity risk.

Of significance here is the large volume of life insurance policies that are currently reinsured, especially in North America. Holding this "mortality risk" (where claims are paid when people die) provides a significant offset against longevity risk and reinsurers that hold alongside each other can hold less capital as a result. A reinsurer holding just one of these risks would need to charge higher fees to cover the higher capital required. Maintaining an optimal balance of these two risks is one of the key factors that impacts the reinsurance pricing of longevity risk.

> "For all but the largest annuity purchase transactions, the process of implementing a longevity swap will be invisible from the perspective of trustees and sponsors."

HOW MUCH REINSURER APPETITE IS THERE FOR LONGEVITY RISK?

At present there is significantly more mortality risk within the global reinsurance sector than longevity risk. Many countries have primarily relied on the state sector to provide pension, so longevity risk largely sits with future generations of tax-payers. However, the market for insured longevity risk is currently growing far quicker than for mortality risk and at some point, the optimal diversification between the two will be reached. Although not immediately a constraint, this strong relative growth in longevity risk may impact pricing in the medium term.

Despite this, reinsurance appetite for UK longevity risk is likely to remain strong in the near term. One of the key constraints at present being simply having enough people within the organisation to keep up with demand. A key threat to near term capacity is the emergence of other markets for longevity risk transfer (such as the US or Canada) which may start to take up more attention given the closer offset to many reinsurers' large mortality portfolios written in North America.

MATT COLLINS
SCOR

Matt is Head of Longevity Business Development at SCOR where he is responsible for all stages of deal execution from managing pipeline through to treaty execution and onboarding of new agreements. He is a qualified actuary with over 17 years' experience helping some of the UK's largest schemes working in both consultancy and reinsurance roles.

MALLOWSTREET
IN PARTNERSHIP WITH ROTHESAY LIFE
Pension Risk Transfer Report

75%
of schemes with assets over **£10bn** think they are too big for insurers

PPF+ cases and considerations

A GROWING NUMBER OF PENSION SCHEMES ARE ENTERING A PENSION PROTECTION FUND (PPF) ASSESSMENT PERIOD, WHICH ARE OVER-FUNDED ON THE PPF BASIS.

This trend is set to continue as corporate insolvencies increase following the Covid-19 pandemic. Whilst these schemes will not transfer to the PPF, they must still go through PPF assessment. Trustees must eventually secure members' benefits by the purchase of annuities from an insurer.

This article provides some guidance to trustees as to how they can navigate the complex legal, financial and practical issues arising out of dealing with

"PPF+" cases.

PPF+ cases –

AND CONSIDERATIONS

APPOINT SPECIALIST ADVISERS

The PPF operates a number of specialist panels providing trustee, actuarial, administration, legal and audit services to schemes in PPF assessment. It is vital that trustees make use of these advisers as they have significant experience of all issues arising in PPF assessment, including dealing with PPF+ cases. Trustees should also consider the appointment of a risk transfer specialist who has a proven record of dealing with these types of transactions.

UNDERSTAND SCHEME FUNDING POSITION

Trustees should seek early input from the scheme actuary as to whether the scheme is likely to be able to purchase benefits above PPF compensation levels with an insurer, as this will determine how PPF assessment progresses.

The scheme actuary should be asked to estimate the scheme funding position using the PPF's prescribed assumptions and taking into account current realistic pricing from insurers (which could differ). The scheme actuary should take into account those areas where the PPF might permit greater flexibility e.g. mortality experience or costs and expenses.

Adopting different assumptions in these areas may mean that a scheme, which looks under-funded on the PPF basis, could, in fact, secure members' benefits in excess of PPF compensation.

Conversely, the scheme actuary should consider whether a scheme that appears to be over-funded on the PPF basis will actually be able to secure members' benefits with an insurer in practice. This situation can arise because the PPF's prescribed assumptions are not necessarily reflective of current insurer pricing.

REVIEW INVESTMENT STRATEGY

Trustees should seek advice on the investment strategy to adopt during PPF assessment. If the PPF will ultimately assume responsibility for the scheme, the PPF will want the trustees to adopt a strategy that matches the PPF investment strategy. However, if the scheme is likely to be over-funded on the PPF basis, different considerations apply.

Trustees will want to adopt a position that fully hedges interest rate and inflation risk relative to the PPF+ benefits that they ultimately want to secure with an insurer. Further consideration also needs to be given to adopting an investment strategy that reflects the assets held by an insurer. This might ultimately be used to support an in specie premium payment or a price-lock mechanism, once the successful insurer has been selected.

Trustees will also need to factor into the process the likelihood and timing of any recoveries from the scheme's insolvent employer.

TOP 5

PPF+ cases

Name	Year	Size (£m)	Insurer
Nortel Networks	2018	2,400	L&G
Turner & Newall	2011	1,100	L&G
Uniq	2011	830	Rothesay Life
Lehman Brothers	2015	675	Rothesay Life
Undisclosed	2014	370	Rothesay Life

ADAPT PPF ASSESSMENT PERIOD TASKS

Much of the work required during PPF assessment would be completed for any solvent wind-up. These tasks include identifying the scheme's benefit structure, data verification and cleansing, benefit audit and rectification (including GMP equalisation), member tracing and pensioner existence checking. Trustees need to think about whether any of these PPF assessment tasks should be adjusted to reflect the fact that members' benefits are to be secured with an insurer. The PPF does not, for example, routinely seek marital information from members but an insurer may find this information useful and this data could improve an insurer's pricing.

DECIDE HOW TO ALLOCATE SCHEME ASSETS BETWEEN MEMBERS ABOVE PPF COMPENSATION

Trustees need to consider how to allocate a scheme's assets between its members above PPF compensation as full scheme benefits are unlikely to be secured. Legislation dictates how assets are to be distributed to members where full scheme benefits cannot be secured. Broadly speaking, the value of each member's PPF compensation is allocated first, with the remainder of the scheme's assets then being divided proportionately between members. This division would usually involve applying the same percentage difference to each member between their PPF compensation entitlement and their full scheme benefits.

DECIDE FORM OF BENEFITS TO SECURE

Once the scheme assets have been allocated between members, the trustees must then decide the form of benefits to secure. Legislation enables members to secure members' benefits by the purchase of annuities, transfers to other registered pension schemes or lump sum cash payments (e.g. winding up lump sums). However, legislation does not dictate the form of benefits to secure; this is a matter for the trustees to determine.

Trustees may typically secure either (a) PPF compensation levels with an appropriate uplift; (b) a percentage of full scheme benefits; or (c) a benefit structure determined by the trustees to ensure the greatest value is delivered to members.

BE AWARE OF LEGAL UNCERTAINTY

The exact nature of PPF compensation is in a state of some flux following recent decisions of the Court of Justice of the European Union (CJEU) in Hampshire and Bauer and subsequent judicial review proceedings brought against the PPF. Trustees need to take legal advice on whether these judgements apply to schemes securing benefits outside of the PPF.

Readers will be aware that, broadly speaking, Hampshire requires members to receive at least 50% of the value of their full scheme benefits if their employer enters insolvency, whilst Bauer requires that the application of the 50% value test does not take members below the "at risk of poverty" threshold as determined by Eurostat.

CONSIDER MEMBER OPTIONS

Trustees need to consider whether they will offer options that members would otherwise have in a solvent wind-up situation after the end of PPF assessment. This would include the ability to transfer out or commute their benefits for a lump sum cash payment (e.g. trivial commutation or winding up lump sums). By default, these options are not permitted during PPF assessment. However, they may be offered during PPF assessment and then validated by the PPF in limited circumstances.

Jonathan is the Managing Director of Open Trustees Limited. Open Trustees Limited is a member of the PPF panel of trustees and has extensive experience of dealing with PPF+ cases.

JONATHAN HAZLETT
Open Trustees Limited

SEEK PROTECTION FROM LIABILITY

The statutory discharge provided by the PPF if it assumes responsibility for a scheme, is different to the discharge provided by an insurer following the purchase of a bulk annuity contract. Trustees should consider different forms of insurance to protect themselves from further liability, particularly as the scheme's employer will be insolvent. Trustees may want to consider the purchase of residual risk cover, seek run-off and missing beneficiaries insurance or some form of PPF benefit guarantee, which will ensure that members will always receive PPF levels of compensation.

KEEP THE PPF INFORMED

Whilst a scheme is in a PPF assessment period, it is vital that trustees keep the PPF fully informed throughout the process. The PPF has an interest in the outcome of PPF assessment until all members' benefits are secured with an insurer. The PPF should be consulted about all issues including the investment strategy to adopt, any decision by the trustees to enter into a buy-in contract, the adjustment of PPF assessment tasks to suit insurers' requirements and the costs associated with the buy-in/buy-out process.

PPF+ cases:

AN INSURER'S PERSPECTIVE FROM ROTHESAY LIFE

Our perspective is that PPF+ cases should always be taken seriously for several reasons: they have been independently verified as being able to afford a buy-out; if they can afford it, they are almost certain to transact; they are usually well run, by professional trustees who are used to doing such buy-outs; the benefits are usually simple; the data has usually undergone significant cleansing activities; and the asset strategies are usually simple with a high degree of hedging.

Whilst all of the above does not guarantee a smooth transaction, it is a very good point to be starting from. The further points to consider to get the best out of Rothesay Life and other insurers include:

1. Establish the funding level early on – whilst the PPF update their basis periodically and it will be a good guide, the best guide to buy-out pricing will always be to ask a provider. Given the simplicity of PPF benefits, it should be straightforward to test the funding level with the market before committing significant expenses for schemes which are marginally funded. This will provide confidence to the PPF and trustee but also to insurers when the process comes back for competitive bids.
2. Provide clarity on timing and process – for quite legitimate reasons, PPF cases can take a long time and there are also additional complexities to negotiate such as whether a transaction should be completed before or after exiting PPF Assessment and when and how will benefits be finalised. Planning ahead and communicating clearly how this will work is important in convincing insurers the process is real.
3. Communicate early what other features will be important – for example treatment of member options and other aspects such as residual risks cover. PPF cases are not "one-size-fits-all" and, as with any case, being clear on what is important to you will be key to getting the best engagement with insurers.

Selecting insurers

Chapter 3

Is premium certainty needed?

As a trustee you have managed your scheme well and now found yourself in a position where you are able to approach the bulk annuity market. You have carefully considered which advisers to have by your side and together you have prepared well.

Your data is in good condition, you have carried out a feasibility exercise to show the market that a buy-out is affordable and you have considered your investment strategy. You come to market with a clear hurdle price and a well thought out process.

Competition has been strong throughout the process and now on the eve of receiving best and final offers from the insurers you and your advisers need to decide which one is the best partner for your scheme. Of course everyone is immediately drawn to the headline premium, but this doesn't always tell the full story. Knowing what is included in each of the insurer's premiums is important and understanding how much premium certainty each is offering should be carefully considered, especially in times when markets are volatile.

Premium certainty is less common than you may think in a bulk annuity transaction and a traditional bulk annuity comes with a few moving parts. Let's look at these in turn alongside ways to mitigate them and create ultimate price certainty at the point you select your insurer.

THE HEADLINE PREMIUM

When insurers provide a best and final quotation it will be based on a market conditions date in the past. This is the date used by all insurers for inflation assumptions, interest rates and investment spreads. Using a set date does make sure that all insurers are quoting on a consistent basis but it also means that by the time you are considering the proposals the premiums will have changed, and so will the value of your assets. It is then a more difficult task to understand how insurers' pricing may have moved since – each insurer's price will move in a different way and this will depend on the underlying assets they are assuming will be used to fund the transaction. This is not something the trustee usually has sight of.

To gain premium certainty during the period between exclusivity and inception a price-lock can be put in place. At the point exclusivity is granted it's possible to convert the premium into a portfolio of assets (the "price-lock portfolio"). From that point forward the scheme is able to monitor how the premium is changing during the exclusivity period by tracking the specified assets. Ultimate premium certainty is achieved when the insurer is able to create a price-lock portfolio that is made up of assets already held by the scheme and offer this price-lock from the market conditions date of the best and final quotation (if it's not too far in the past). The premium can then be paid simply by transferring the scheme assets to the insurer at inception of the policy.

THE BALANCING PREMIUM

In most bulk annuity transactions an initial premium is paid at the policy inception, and then after the data cleanse period (usually around 12 months after the initial premium is paid) a balancing premium is paid to reflect the cleansed member data. This balancing premium could either be additional money owing to the insurer or a refund to the scheme. The balancing premium will very much depend on the accuracy of the scheme data and any specific cleansing actions that were identified during the insurer's due diligence process. The cost of the balancing premium will be unknown at the point of inception and therefore it is very difficult for the trustee to know the full cost of the transaction when selecting an insurer. Whether the balancing premium is positive or negative, it can create issues – such as affordability or "trapped surplus".

A single premium structure allows the trustees to pay an up-front premium that covers everything. There will be no balancing premium to be paid at a later date. This structure will allow trustees and the sponsor to have sight of the total cost (net of expenses) of the transaction before entering into the contract, with no surprises to come later. An up-front premium that covers everything is only possible if the insurer is willing to underwrite the risk and any additional costs associated with the data cleanse period. In a transaction with a finite budget (which is most!) this structure allows trustees to react quickly to favourable pricing knowing that there will be no further premium required.

THE RESIDUAL RISKS

No scheme is completely free of outstanding risks once it has entered into a buy-in or buy-out, and from time to time issues may come out of the woodwork that are not covered by the insurance policy. Perhaps even some of those benefit gremlins that Susie and Niamh discussed earlier on in the publication (see page **26**). Missing beneficiaries may also come to light or data errors that the trustee wasn't aware of. These types of liabilities will need to be met by the trustees at the point they become aware of them. But how does a trustee ensure that they have enough funds to meet these potential liabilities? And how can any trustee take this into account when selecting their insurer?

The trustee could consider purchasing residual risk cover. Many insurers offer the ability to purchase this cover up front as part of the initial transaction or at a later date when winding up the scheme. Residual risk cover will provide premium certainty around any "unknown unknowns" from the point that the cover incepts. Understanding what each insurer is willing to offer and the scope of the cover is important during the initial insurer selection.

Residual risk cover can also be offered from the point of inception on buy-out transactions, for a fixed, upfront premium. This, together with a single premium structure, achieves ultimate security for trustees and their members.

Considering each of the structures I have mentioned above is probably something you should do before approaching the market. Each insurer's solution is likely to be a little different, so remember, don't be blinded by the headline premium, carefully consider what each insurer is offering and think about how much premium certainty you will require.

RÓISÍN O'SHEA
Rothesay Life

Róisín is part of Rothesay Life's Business Development team. She has worked on a wide range of transactions and played a lead role in the £3.8bn transaction with Allied Domecq in 2019. Róisín has spent most of her career focused on pension de-risking and has previously worked at Aviva and Legal & General in their bulk annuity teams. Róisín is a Fellow of the Institute of Actuaries and has received the Chartered Enterprise Risk Actuary accreditation.

The bidding process: is it all about price?

"Price is what you pay, value is what you get."

While Warren Buffett was "talking about socks or stocks" when he said this, the phrase is also relevant for any trustee purchasing bulk annuities, where value can be achieved through both transaction structuring and the choice of counterparty. There are many cases where the insurer providing the best price has not been the chosen insurer – because they have not provided the best value.

MALLOWSTREET
IN PARTNERSHIP WITH ROTHESAY LIFE
Pension Risk Transfer Report

9%
of schemes are focusing on finding a counterparty to transact with

The bidding process

IS IT ALL ABOUT PRICE?

TRANSACTION STRUCTURING CRITERIA

Once final insurer prices have been provided, the decision to go ahead with a transaction or not will typically depend on whether insurers have beat the hurdle set by the trustee. As well as the relative headline prices though, trustees and sponsors need to consider:

1.
How each insurer's price will move during a period of exclusivity – is there a risk that pricing could become unviable over 2–6 weeks of contract negotiations or is the value "locked in"?

2.
How the premium will be paid – are there transaction costs associated with selling assets to pay cash to one insurer that could be transferred in specie at no cost to another?

Both of these areas can create or destroy value in any transaction and make a difference to which insurer is providing the best economic terms.

Trustees should also consider the contractual terms offered. For instance, the extent to which different insurers can provide an exact match to the benefits paid by the scheme, the flexibility to carry out future strategic initiatives such as GMP equalisation (and any associated constraints), the certainty relating to the impact of any future data and benefit changes, and the ability to offer members benefit flexibility in the future, are all examples of non-price factors that should be carefully considered when choosing an insurer.

A good example of this was Asda's £3.8bn transaction, which was a complex full scheme buy-out. In addition to requesting a headline price, we also sought insurer proposals in over 20 different structuring areas as part of the tender process. In practice, not all of these would have individually swung the insurer selection decision one way or another, but it highlights that there is significant value in many areas beyond just price.

"Striking the right balance between price and wider commercial terms is a careful balancing act."

COUNTERPARTY ASSESSMENT CRITERIA

Alongside structuring, as part of the value assessment of any transaction, trustees and sponsors must be confident that their chosen insurer has a robust financial and operational proposition. This includes an assessment of:

- Financial strength – this should span a range of areas including current levels of solvency, access to further capital and investment strategy;
- Administration capability – this should consider a variety of aspects, including service levels, resourcing, communications and policyholder views.

It is also often the case that trustees and sponsors determine their own criteria when assessing insurers. Again, on the Asda transaction, this included the views of the in-house administration team on how insurers had conducted themselves during due diligence (as a proxy for what insurers would be like to work with on implementation of the policy), and the confidence that their investment advisers had in insurers to manage execution risks associated with the the in specie transfer of the scheme's assets (as an insight into the insurers' ability to manage investment risk).

STRIKING A BALANCE

Having said all of the above, price will be a crucial factor on any bulk annuity transaction. As such, it is vital to maximise the engagement of insurers.

"Standing out from the crowd"
to ensure that your transaction is prioritised is essential in achieving the best possible pricing. Striking the right balance between price and wider commercial terms is a careful balancing act and requires an understanding of what increases and decreases insurer engagement.

Overloading insurers with too much paperwork early on, can act as a distraction from achieving the best price yet failing to be clear about important commercial terms risks losing competitive tension during the insurer selection process. Accordingly, optimising this balance is the key to achieving value in the current busy bulk annuity market and requires a deep and current knowledge of both:

1. **The terms available across all insurers for transactions of different sizes, and**
2. **An understanding of how insurers determine which cases to prioritise and to deploy their best pricing towards.**

Finally, in our experience, insurers respond well to schemes that have well thought through expectations and requirements in relation to commercial terms. Along with well prepared data and benefit specifications, having a clear set of terms available early in the insurer selection process demonstrates a strong sign of transaction certainty and helps insurers put their best foot forward as early as possible.

MIKE EDWARDS
Aon

Mike is a Partner in Aon's Risk Settlement Group and is responsible for advising trustees and scheme sponsors on de-risking strategy and implementation. In 2019, Mike led the advice and negotiation on c.£10bn of completed transactions, including for Asda and National Grid.

MALLOWSTREET
IN PARTNERSHIP WITH ROTHESAY LIFE
Pension Risk Transfer Report

44%

of schemes affect their sponsor's ability to grow

"...price will be a crucial factor on any bulk annuity transaction. As such, it is vital to maximise the engagement of insurers."

DOES INSURER FINANCIAL STRENGTH REALLY MATTER?

The choice of an insurer to transact with on a defined benefit (DB) pension risk transfer exercise, such as a buy-in or buy-out, has historically tended to come down to price.

The deep-rooted perception in the UK pensions market is that the insurance regulatory regime, with all its oversight, safeguards and protections for policyholders, serves as the ultimate underwriter of insured benefits. This view has tended to relegate any financial strength distinction between competing insurers to a second-order or last-minute window dressing consideration. Not only does this perception fail to grasp the limits of our financial architecture but its implications on trustee decision making could get extensively tested by the economic ramifications of Covid-19.

1. An annuity is a very serious business: Part Two, David Rule, Bank of England, April 2019

It is widely accepted that the life insurance regulatory regime is strong, offering greater security than your typical employer covenant where explicit capital buffers to underwrite adverse future experience are seldom held. However, the same regime also grants each participating insurer with some flexibility to adopt its own risk and reward profile.

The insurance regulator, the PRA, openly discloses that the insurance regime does not seek to "eliminate all risk (to achieve the stability of the graveyard)"[1]. The regime is instead meant to establish a minimum set of principles and requirements insurance providers must abide by. That means that no two insurers are expected to offer the same risk profile to its policyholders, lenders and shareholders. Look under the bonnet of any two life insurers and you will find a significant variation on investments, underwriting standards and risk appetite.

In the UK, long-term pension policies are covered by the Financial Services and Compensation Scheme (FSCS), the industry-wide "safety-net". It is not lost on industry legal experts that UK courts have over the years clearly established that the mere existence of the FSCS does not make the transfer of liabilities from and to insurance companies appropriate. The decision ultimately relies on the relative assessment of the insurers across a range of relevant factors.

UK courts understand that the FSCS, which is funded by an annual levy mechanism and, by contrast to the PPF, does not set aside assets to meet existing and future obligations, is an exercise in mutualising only a proportion of the total obligations underwritten by financial institutions. This leaves the FSCS more exposed to systemic failures as we saw during the global financial crisis when it was forced to seek emergency funding from the Bank of England to meet a surge in claims.

Whilst there is currently no legislative requirement in the UK for schemes to explicitly consider financial strength when selecting an insurer, this is not the case everywhere. In the US, where there has been more experience of insurer failures, the Department of Labour's Interpretative Bulletin 95-1 stipulates that selecting an insurer to transfer pension liabilities is a fiduciary decision. Sponsors are required to "conduct an objective, thorough, and analytical search" which evaluates insurers across a number of factors that inform the ability of each provider to meet the claim in full. A high-level assessment of a single insurer or a comparison of headline metrics is not deemed sufficient in that context.

Trustees in the UK are also required to act in members' best interests, so it is not inconceivable that the failure of an insurer (however unlikely it may appear today) could lead to greater regulatory scrutiny about the steps that have been taken by trustees and sponsors to discharge their fiduciary responsibility to members.

The economic impact of Covid-19 is already bringing the question of counterparty risk into sharper focus. And we should not forget that the current economic slowdown will represent the first real test for the Solvency II regime and its capacity to protect policyholders.

The insurance industry is, in general, well-capitalised, but the implications of a deep recessionary environment would be varied across the individual providers given underlying differences. Some providers may actually find that because they have historically run a more prudent investment strategy, they are in a position to write new business and use this as an opportunity to invest for the future. For others, the next 18 to 24 months could represent a comprehensive test of existing contingency plans.

The conclusions of a pre-mortem of the life insurance segment would be clear – financial strength matters, and it should be carefully considered when selecting an insurance provider to transact with. Looking beyond the confines of the UK bulk annuity market (BPA) segment, there is ample evidence to support the view that it is not sufficient nor appropriate to simply rely on the potential support that could be provided by the insurance regulatory regime. To do so would be similar to trustees relying on TPR and the PPF rather than taking account of specific employer and scheme characteristics.

A robust brokering process is one that considers the financial strength of market participants from the onset. There is little doubt that insurers in the BPA market segment are different from one another, and it is important that trustees and sponsors understand what makes each insurer "tick" when deciding which provider to exclude from the process. Advisers play an important role in making them aware of this dynamic. The choice of an insurer will have long-lasting implications on the welfare and livelihoods of members, so the decision should not be made purely on price.

MICHAEL LUO
Lincoln Pensions

Michael is an Associate Director at Lincoln Pensions and is a qualified Actuary. Since joining Lincoln in 2017, Michael has advised trustees and sponsors on matters related to employer covenant. In addition, Michael is also a core member of Lincoln's "end-game risk-transfer" practice, advising schemes on pensions risk transfer exercises.

ADOLFO APONTE
Lincoln Pensions

Adolfo is a Managing Director at Lincoln Pensions where he leads Lincoln's "end-game risk-transfer" practice, advising pension schemes, corporates and financial sponsors on a wide range of corporate transactions and funding structures. Many of his clients are in the financial services industries, including insurers, banks and asset managers.

Regulation of insurance companies in the UK

All companies carrying out insurance business in the UK are authorised by the Prudential Regulation Authority (PRA) and regulated by both the PRA and Financial Conduct Authority (FCA). The PRA and FCA have extensive powers to supervise and intervene in the affairs of insurers to protect policyholders. This includes the ability to sanction companies and individuals.

Any change in control of an insurer must be approved by the PRA who must also consult with the FCA.

Insurers must comply with the Financial Services and Markets Act 2000 as well as the rules made by the PRA and the FCA. Prudential standards require (amongst other things) that insurers are suitably resourced and that they have appropriate risk management systems and controls. The Senior Managers & Certification Regime ensures that the appointment of key individuals is subject to regulatory approval and ensures individual accountability. Conduct of business rules make sure that business is conducted fairly.

"From 1 January 2016 insurers have been subject to the Solvency II regime which will still apply post-Brexit unless alternative rules are adopted."

From 1 January 2016 insurers have been subject to the Solvency II regime which will still apply post-Brexit unless alternative rules are adopted.

The regime has three pillars:

PILLAR 1:
quantitative requirements covering the amount of capital an insurer should hold

PILLAR 2:
qualitative requirements in relation to risk management and supervisory activities

PILLAR 3:
enhanced public and supervisory disclosure. For example, all insurers are required to publish a Solvency and Financial Condition Report setting out information in relation to governance, risk management and solvency.

Under Pillar 1, insurers are required to hold sufficient assets to cover:

- Their technical provisions which consist of a best estimate of their liabilities plus a risk margin. The risk margin is intended to be the discounted value of the future cost-of-capital relating to risks (other than hedgeable market risks) required to be held under Solvency II; and
- Capital required to have a 99.5% confidence that the insurer could survive the most extreme expected losses over the course of a year (the solvency capital requirement). For insurers writing life assurance or travel insurance that might be the impact of a pandemic such as Covid-19. For annuity providers, it could be the impact of a financial crisis.

Liabilities must generally be discounted at a risk-free rate of interest but insurers with illiquid liabilities such as annuities are permitted to discount their liabilities using the risk-free rate plus an illiquidity premium (the matching adjustment) derived from the risk-adjusted yield on the assets backing the liabilities. In order to qualify, these assets must have fixed cashflows, i.e. be assets such as corporate bonds and gilts. Assets such as equities and property would not be eligible. And of course, to the extent that insurers invest in riskier assets they must also hold additional solvency risk capital. In addition, insurers are required to abide by the prudent person principles when making investments. These ensure that insurers only invest in assets whose risks they can properly identify, measure, monitor, manage, control and report.

The board of the insurer determines its risk appetite – the risks it is prepared to take, the risks it wants to minimise and the solvency range it wants to target. Insurance companies are required to put in place recovery plans which would automatically be triggered were solvency to fall below the companies' target operating range. Plans might include cancelling dividends, raising new equity or debt, cutting costs, ceasing to write new business, reinsuring more or changes to investment strategy.

Ultimately, in the event of problems, the PRA has extensive powers to intervene including the ability to prevent dividends and to revoke approval to write new business.

99.5%

Insurers must hold enough capital to have 99.5% confidence that they could survive the most extreme expected losses over the course of a year

ANDREW STOKER
Rothesay Life

Andrew is the Chief Financial Officer of Rothesay Life. Andrew joined Rothesay in 2014 and is responsible for the finance, actuarial and HR functions. Andrew was previously a partner in EY's risk and actuarial practice and prior to that was Chief Actuary at Lucida plc.

EXCLUSIVITY TO INCEPTION

"Are we there yet?"

The answer is:

"Not quite"

Having worked for trustees and sponsors, and both within and for insurers, it is clear how much hard work goes into getting a transaction to the point of exclusivity. It is only natural to feel that this is the milestone you have all been working towards and it prompts the question, "Are we there yet?"

Exclusivity to inception

"ARE WE THERE YET?"

The period of exclusivity has its own pressures and challenges. Some deals, although thankfully very few, have fallen over or been put on hold during this time. As with most journeys you need to remain focused in the final stages. Being prepared for what is next is key to staying on track.

What should you expect?

During exclusivity, there will be a number of moving parts, all with the (likely) backdrop of a time-limited price-lock that is ticking away daily. Your administrators and data will be subject to further analysis and scrutiny and you may need to facilitate site visits. Assets will need to be transaction ready and at the same time, the legal documentation will be negotiated.

MALLOWSTREET
IN PARTNERSHIP WITH ROTHESAY LIFE
Pension Risk Transfer Report

55%

of those working towards buy-out expect to achieve it in

TEN YEARS

WHAT SHOULD I LOOK OUT FOR IN THE LEGALS?

For many trustees, this will be their first experience of a bulk annuity contract. The agreements vary from insurer to insurer but some key clauses are likely to be of particular interest:

ON RISK DATE: it is important to understand when the insurer will be on risk for your pension liabilities. This could be as soon as the contract is signed or not until all of the premium hits the insurer's bank account. Make sure you are comfortable with any delay and that it is entirely clear when the risk will be with the insurer.

WARRANTIES: most insurers will require significant trustee warranties to ensure that everything is in order. These will usually range from making sure you have authority to enter into the arrangement to confirming that the benefits being secured by the insurer are what members are owed. Most warranties are given when you enter the arrangement but some may also be required when you move to buy-out. You will need to ensure you understand the extent of these warranties and that wherever appropriate, they are backed with the right questions to, and comfort from, your advisers.

LIMITATION OF LIABILITY: closely linked to the warranties, you will want to understand how your liability is limited (usually to the assets of the scheme). You may need to consider how an employer indemnity or run-off insurance could help here.

MATERIAL CHANGE: although you will have a price and likely a price-lock that gives you certainty as you enter into a transaction, insurers will usually require a re-price right in the future. The triggers for a re-price vary but all centre around the idea of material change; the insurer is protecting itself against the liabilities not being what they expected when they entered into the transaction with you. It is important to understand what these triggers are. For most schemes who have prepared their data and benefits well in anticipation of a transaction, these shouldn't pose an issue.

TERMINATION: insurers are generally reluctant to include termination provisions as bulk annuities are very much viewed as long-term partnerships. There may, however, be termination events linked to non-payment of the premium or fraudulent or negligent behaviour by the trustees. You will want to understand what could trigger termination, especially as the amount you receive after a termination event will be less that the premium you initially paid.

"...things may change as the exclusivity period progresses – you will need to be ready to react."

ANY TIPS?

1. **Preparation is key** – Although it won't guarantee a seamless exclusivity period, it will mean problems are less likely to occur. Having your benefit specification and data in order and ensuring your advisers are geared up and on board will all pay off in the long run.

2. **Right advisers** – given the nature of the policy and the tight timescales involved, trustees and sponsors are increasingly querying whether their usual scheme advisers are necessarily the right ones to guide them through a bulk annuity transaction. Although there is no doubt that existing advisers are best placed to understand the benefits and the scheme history, many trustees are seeing the benefit of using specialist bulk annuity consultants and legal advisers in order to ensure a smoother transaction.

3. **Plan** – although not very glamorous, having a clear and well thought out timetable and project plan as you enter exclusivity is always worth it. You will want to make sure the trustees are meeting at the right times during this period. Are the discussions with asset managers all taking place at the right time? Will you have legal documentation in enough time to review and get advice on what you are entering into? Bear in mind that the insurers may also have their own timing concerns around full and half year ends.

4. **Remain nimble** – you will be limited on time and things may change as the exclusivity period progresses – you will need to be ready to react. Many trustees benefit from a smaller working group who can meet quickly and have the authority to take decisions to keep the deal on track.

This period of exclusivity is truly exciting and you are definitely

"nearly there".

Perhaps the greatest piece of advice is to ensure you have chosen the right insurer as your partner – they will be most likely to determine whether this last leg of the journey will be a smooth one.

AMRIT MCLEAN
DLA Piper

Amrit is a Partner and Head of De-risking at the global law firm, DLA Piper. She has 14 years' experience in pensions de-risking, working within the business teams of two major insurers and in private practice advising both insurers and trustees on their bulk annuity transactions.

Completion and implementation

Chapter 4

A journey to buy-out with telent

In September 2019, Rothesay Life secured the benefits of the c.39,000 members of the GEC 1972 Pension Plan (the Plan) with a £4.7bn bulk annuity, the largest pension fund to secure a buy-out to date.

In this case study, we will look at the Plan's journey to buy-out, approach to market, and some key learning points of the transaction.

BACKGROUND

In the early 2000s, Marconi sold the majority of its business to Ericsson, and rebranded itself as telent. As part of the M&A , £500m was placed in an escrow account to support the very large pension scheme that was retained by telent, and which overshadowed the size of the remaining business.

Over the following decade, given the asymmetry between the size of the sponsor and the size of the Plan, the Trustee board concluded that they had to manage the Plan on the basis that there was no associated sponsoring employer. Key decisions were made to de-risk the assets, hedge interest rates and inflation (including the caps and floors in respect of pension increases) and try to improve the funding level of the Plan with the aim of securing a buy-out by 2034.

APPROACHING THE MARKET

After following this plan for a number of years, the Plan had made significant progress on its funding position, ahead of schedule. At the end of 2018 the Trustee and sponsor together completed an initial feasibility analysis and found that they were closer to buy-out than expected.

A joint working group then set about planning and preparing to come to market. They had initial meetings directly with insurers, to find out more about the process, their appetite and capacity over 2019. Aon were appointed as specialist bulk annuity advisers to broker the business, and CMS were selected to cover the legal aspects of the transaction.

The Plan also carried out extensive due diligence on its historical documentation in preparation for the transaction, and completed a comprehensive data and administration audit with the in-house administration team.

This focused groundwork meant that the trustee and the sponsor came to market ready to transact and with a clear set of objectives to be met in order for the buy-out to take place.

THE QUOTATION PROCESS

The direct articulation of objectives allowed the team at Rothesay Life to focus our resources on creating a tailored solution to meet the needs of all stakeholders. We were also able to accelerate our own due diligence process because of the thorough preparation steps taken by the trustee.

Together this enabled us to provide a fully underwritten, guaranteed premium, ahead of schedule. The premium was expressed in terms of a subset of the Plan's assets, which would then move in line with this portfolio of assets up until the time it was transferred to Rothesay Life (please see the article from Tom Seecharan for further details).

The trustee and sponsor had a clear governance process which meant that they could respond quickly to accept our accelerated offer. Our ability to offer price certainty and mitigate execution risk during volatile markets made us an attractive partner for the Plan.

The premium also included cover for residual risks from the point of inception, giving the trustee full certainty on the costs of moving to buy-out.

LEARNING POINTS

- Preparation is key – focus on understanding your data, the scheme benefits to insure, and any potential legal issues ahead of coming to market
- Clarify your objectives – and communicate these to insurers
- Appoint the right advisers – a specialist broker or legal adviser may be beneficial. particularly for transactions with residual risk cover
- Review your assets with insurers in mind – consider any trading or liquidity restrictions, and raise any potential issues with insurers early
- A collaborative mind-set can make deal completion smoother and ensures all parties' needs are met. At Rothesay Life, we tend to see each transaction as a joint venture between us and the Trustees, with everyone is working together to achieve the same outcome – a successful transaction!

COMPLETING THE TRANSACTION

Over the next two months, we worked with the Plan and their advisers to complete the transaction as smoothly as possible.

Our trading team worked closely with the Plan's investment team to ensure the assets were being tracked and valued accurately. There were also some illiquid investments held by the Plan that could not be transferred to Rothesay Life, so a plan to sell those positions over the coming months was agreed.

Rothesay Life's dedicated transition team had already met with the administration team as part of the quotation process, but this close work continued throughout the execution phase to ensure all parties were comfortable with the ongoing requirements under the policy. The teams continue to work together on the next phase of the journey to buy-out and eventually, wind-up of the Plan.

The buy-out is expected to be completed in 2021, at which point all members of the Plan will have their benefits fully covered by individual policies with Rothesay Life.

CLEO TAYLOR SMITH
Rothesay Life

Cleo is part of the Business Development team at Rothesay Life, and has worked on transactions with the pension schemes of National Grid, telent, Asda, Cadbury and ESAB, amongst others. She also has experience of pricing bulk annuities having joined Rothesay Life as part of the new business pricing team in 2016. Cleo previously advised trustee and corporate clients on pensions issues at Willis Towers Watson, and is a Fellow of the Institute and Faculty of Actuaries.

£4.7bn

Bulk annuity, the largest pension fund to secure a buy-out to date

"This transaction is great news for all the members of the scheme. Since 2005 the pension scheme has been much bigger than telent, and so it was in everyone's interests to secure a buy-out once this was affordable. We were delighted to reach that goal 15 years earlier than planned, following many years of careful investing and strong governance."

PETE HARRIS
Secretary to the Trustees and Pensions Director at telent

"At every stage of the process all parties have worked constructively to achieve this landmark settlement and we are delighted to be providing a secure, long-term home for the 39,000 GEC Plan pensions."

SAMMY COOPER-SMITH
Head of Business Development at Rothesay Life

MALLOWSTREET
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Pension Risk Transfer Report

87%

of schemes are de-risking their investments

Investment considerations

So, you have run a competitive process to agree a price; you have reconciled the cashflow modelling and benefit specification with the legal documentation and the administration practice; the covenant reviews are complete; and the key contractual terms have been negotiated. All that remains is to sign the contract and pay the premium.

Investment considerations

There are many considerations here also.

How will the premium move with changes in market conditions?

Can you immunise yourself from such changes?

What assets will the insurer accept and what will you need to sell?

Do you need to novate or close-out any swaps?

Making sure you are well prepared on the asset side of the transaction is key so we have attempted to pick out a few of the most important considerations here.

PLANNING AHEAD

One of the most common questions that pensions schemes ask us when they are starting to contemplate buy-out is: What is the best mix of assets to hold as they approach the market? Should they hedge with gilts or swaps? How many corporate bonds should they hold? The short answer is it depends on what you are trying to achieve.

If you have reached full funding and just want to reduce any volatility while you approach the market, then full hedging with either gilts or swaps, plus some limited exposure to corporate bonds (less than 50%) will achieve this. Achieving perfection isn't really possible as different insurers' prices will move differently so you can't match them all. There is more on this subject in the article by Mette Hansen on page **42**.

If you are looking for a smooth asset transfer by holding assets that an insurer will take as payment, then gilts are very simple to transfer, corporate bonds should be also (although it will depend on how you hold these bonds and insurers may not want to hold all the same bonds), and it may be possible to novate swaps but this will depend on the details of the swaps and who the counterparty is etc. There is more on this subject in the article by Dan Hardiman on page **88**. Where other asset classes are held, it is most likely they will need to be sold and the earlier this planning starts the better (particularly higher risk or illiquid asset classes).

GIVING YOU ABSOLUTE CERTAINTY

When you buy a house, the chances are you agreed a fixed price, your deposit is held in cash and your mortgage is for a fixed amount also. Even if the purchase takes months to complete, you don't need to worry about your assets and liabilities moving apart from each other. With a bulk annuity things are more complicated, but there are still ways to get this risk under control:

- **Price-lock** – is an agreed mechanism that the insurer tells you in advance for how the premium will move. This means you can work out in advance how the premium will move versus your assets over the month or two that it might take to complete the transaction and whether you need to make any changes to bring the two in line.
- **Price-lock portfolio** – a price-lock is often set out as a complicated formula but it is sometimes expressed instead as a list of assets. This can be easier to understand and, more importantly, it means you could buy those assets and deliver them as payment also. This simultaneously removes a source of risk and ensures a quick and easy premium payment process. Win-win.
- **Gilt-lock** – this is a price-lock portfolio where the only assets listed are gilts. At Rothesay Life this is our standard approach. In addition to the gilts having the same value as the premium, we also design the gilt-lock to have the same risk profile (both interest rates and inflation) as the underlying liability profile. Typically, we try to reduce your hassle still further by basing our gilt-lock as far as possible on gilts you already own.
- **Asset-lock** – this is the name for a price-lock portfolio which is entirely comprised of assets already held by the pension scheme. This has the benefit that the pension scheme is already completely immunised against price movements and, in the off-chance the deal doesn't conclude, the scheme has not had to make changes to their asset mix which would now need to be unwound, potentially at great cost.
- **Price-lock period** – the period the insurer agrees to hold the price-lock for, typically six weeks.
- **Boundary conditions** – sometimes an insurer will build in protection for themselves that, in the event of pre-defined, significant changes in market conditions occurring, the insurer would no longer have to honour the price-lock but has the right to re-price the transaction.

You would be forgiven for wondering why doesn't every scheme just request an asset-lock with a 12 week price-lock period and no boundary conditions? This is not always possible. The size and nature of a transaction will dictate what an insurer is willing to offer. In addition, there may be a trade-off between risk and cost. A long price-lock period with no tramlines is extremely valuable for a scheme because significant market risk is being passed to the insurer and taking on this risk is something they may charge for. All this needs to be considered carefully. A good price with no boundary conditions may actually be a better offer than a better price but with boundary conditions.

What we need to give you our best

These are all important considerations and working with a specialist pension risk transfer adviser will help you through this complex process.

It takes time and a good level of engagement for an insurer to build and refine a price-lock portfolio which best meets a pension scheme's objectives. Providing early visibility on the assets held, setting out a clear objective and allowing us to engage with your investment adviser will give us the best chance to formulate a proposal which works for you.

TOM SEECHARAN
Rothesay Life

Tom joined Rothesay Life's Business Development team in October 2019 and has over 18 years' experience as a pensions actuary advising schemes and sponsors on assessing and managing pensions risk. Previously, Tom led KPMG's UK Pensions Risk Settlement team since 2011.

YOUR ASSETS:
operational considerations

We now look to highlight some of the key operational considerations that the pension scheme should consider in order to manage its risks and obligations in satisfying the delivery of the asset portfolio that at this stage has been agreed as the premium for the insurance contract.

Each scheme will be subtly different in terms of the assets that are held by the scheme and have been agreed with the Insurer during the price-lock period, but likely they will fall into three buckets; bonds (gilts and/or corporates), derivatives (swaps), and cash. Ultimately all assets identified as the price-lock portfolio will be transferred to the insurer to satisfy the premium due, and as such it is key that all parties, the scheme, its custodian/bank and the insurer, have the same view of the assets and this is checked regularly.

Your assets

OPERATIONAL CONSIDERATIONS

We list the key considerations by asset class below.

CUSTODY RELATIONSHIP

As a starting point – and although this may sound obvious its importance should not be overlooked – the scheme should ensure it has an easy way of getting sight of the assets held by its custodian. If the scheme does not have the technology in place to view its assets directly, for example through a custodian portal, it should arrange to do so as it contemplates the buy-out. There should be no additional cost to the scheme of having this access, and it will make the bond and cash reconciliations much easier as the frequency increases. In addition, the scheme should ensure it has a senior relationship contact at the custodian who understands the transaction and can help the scheme with the technical questions an insurer may have – for example designing and delivering any reports that you may need, and helping with specific settlement details with the insurer in the run-up to execution.

BONDS

The reconciliation and delivery of the bonds should be a relatively pain free exercise but there are some subtle points to watch out for:

- **Reconciliations**
  - Notional – ensure you are reconciling the face notional (the actual position you hold in custody and will be delivered to the insurer) and amortised notional where relevant (bonds which have repaid part of its principal balance through the life of the bond).
  - Record/Ex-div date – this is a key date to be aware of in order to track and reconcile expected bond interest receipts (this date determines a holder's entitlement to bond interest), and is particularly important to track if the scheme is buying/ selling assets or posting assets as eligible margin under their swaps.
    - Word of caution! Both the scheme and insurer should be aware of the ex-div date when agreeing the settlement date for the assets to be delivered – if the settlement date falls in between the ex-div date and payment date for a given bond, the scheme will receive the coupon as the holder of the bond on the ex-div date, and will need to transfer this to the insurer as a cash payment.
  - Previous and next interest pay date – the scheme should be aware of these dates to track and reconcile realised and future incoming cashflows which are due over the price-lock period. The insurer will be keen to confirm that the actual payment received matches the expected/accrued, so it can reconcile to its own expected cash balance.
- **Settlement**
  - Pre-execution – the scheme and insurer will need to confirm the logistical details around delivering the bonds to the insurer – this is where the scheme might want to pull in their custodian contacts. The scheme will likely have a five to ten-day period in which to deliver the assets, but in reality this can be achieved within two or three days if both sides are well prepared and agreed on these details. Key points for each bond in the portfolio will be the agreement of:
    - Custody locations (which clearing system does the scheme currently hold the bond in, e.g. Euroclear, Crest etc.);
    - Respective "SSIs" (custody account numbers of the scheme and insurer);
    - Trade date and settlement date to transfer the assets.
  - On execution – the scheme should give the instruction to the custodian to enter into the agreed delivery instructions and should confirm when they are matched with the insurer. This should be confirmed within a day of the instruction to the custodian. Reconfirming the matching status the night before settlement date means the bond delivery should then happen automatically in the clearing systems on settlement date. Ask your custodian (or check the status in the portal!) for regular updates so you are aware, but the insurer should also provide you with these updates.

SWAPS

Where swaps form part of the premium to be transferred, these will be novated away from the scheme and to the insurer on signing date of the contract. The bank with whom you executed the trade remains a constant party to the contract. The swaps are the most complex asset to transfer operationally and we cannot cover all technical points here, but a sophisticated insurer (and your relationship manager at the bank) should be able to guide you through the process – it is a relatively standard process for them and the bank!

- **Legal confirms** – let's start from an assumed position that you have copies of all legal confirmations with your existing banks. Interest rate swaps will likely be electronically confirmed on industry standard systems/platforms such as MarkitWire, inflation swaps will be confirmed on paper. Make sure you have current copies of all confirms reconciled to your systems and have them to hand, ready to send to the insurer when needed.

- **Spreadsheet** – preparing for the price-lock you will want to build a spreadsheet showing the economics of each swap, row-by-row. Include your trade reference so you can easily reference a particular trade (the insurer and bank will also need this to execute the novation). Key columns the insurer will need include currency, effective date, fixed and floating rate, payment dates, notional, day count fraction, maturity date. This will enable the insurer to book and price a reasonably accurate representation of your swap portfolio in its own system.

When you are in the price-lock, you will need to send the legal confirms to the insurer in order for them to fully review the legal terms against their spreadsheet representation – they can effectively risk manage the price-lock from that point as they have built a shadow of your book in their risk system.

- **Cash reconciliation** – the insurer will want to reconcile any cashflows due under the swaps against the payment you are physically settling with the banks (both paying and receiving) in order to ensure their aggregate cash balance is in line with your actual balance – as they did with the bond interest covered earlier.

- **Margin** – assuming the swaps are executed under standard ISDA terms, the scheme will likely be performing daily margin calls against the banks. Ensure you have a clear representation of any margin paid or received to the banks. You will need to recall or return this margin on execution. If you have posted bonds as margin, ensure you are aware of when those bonds are due to pay a coupon (see the ex-div date point above) – you should ask the bank to pay this coupon to you as soon as possible in order that your actual cash balance matches the insurers assumed cash balance.

- **Execution**
  - Pre-execution – you can expect the insurer to line each bank up to novate the swaps from the scheme in the run-up to execution. The scheme will have to discuss the expected novation with their bank but expect the insurer and bank's operations and trading teams to help you through the specific legal and operational points required. The electronically confirmed swaps are novated through the system; the paper confirmed swaps will require a novation agreement, which should be drafted by the insurer (or the bank) and sent for your review.
  - On execution – when the contract has been signed the scheme should initiate the swap novation with the bank and the insurer via email. The insurer and bank will then take the lead on the operational processes to legally confirm the transfer, effecting it either through the electronic system or by the three parties signing the paper confirms.
  - Post-execution – the day after execution will trigger a recall of the margin balance that had been exchanged between the scheme and bank. This will settle either that day or the following day (in line with your standard arrangement). The scheme will then have to pass that recalled collateral through to the insurer, likely one or two days after receipt from the bank to give yourself a buffer against any fails.

CASH

You will be holding a running cash balance at your bank and/or custodian which will simply represent your starting balance plus/minus any cashflows received on your bond portfolio and exchanged on the swaps. It is important to reconcile this balance though as this is the cash balance part of the premium that you will need to transfer to the insurer. Expect to reconcile your actual balance to the insurer's on a weekly basis, which will likely step up to daily in the days running up to execution.

Transferring the cash is a standard wire process but, as with custody, having a good contact at your bank will be important in advising you of the safest way to transfer. Making a test payment of £1 before execution to check you have the insurer's bank details correct would be sensible.

It may be that there are several cash transfers you will make: (i) a lump sum in your account available to transfer immediately; (ii) cash margin to be recalled from the banks and transferred within three to five days of execution; and (iii) bond coupons where you are in the ex-div period that could take anywhere up to 14 days to be received from the Issuer. The insurer should be sensible about agreeing how and when these should best be transferred.

COMPLETION

When all assets have been delivered you are there! The key points to take away to ensure an efficient and well-controlled process are clear communication, regular reconciliations, and management of your third parties. Ask the insurer for help if you are in any doubt. They will have done this before and what may seem a daunting task to you at the outset can be broken down into simple steps at each stage of the process.

DAN HARDIMAN
Rothesay Life

Dan is Head of Asset Operations at Rothesay Life and has been with Rothesay since 2011, post the acquisition of the Paternoster business. Prior to that he worked at Goldman Sachs for 10 years. Dan worked on the integration of Paternoster and Metlife, and the insurance transfers with Prudential, Aegon and Zurich. His day to day work covers Rothesay's asset deployment and hedging activities, liquidity and collateral management, and oversight of key third parties working for Rothesay Life such as custodians and banks.

It’s all about...

trust

The comms challenge of navigating good news

The comms challenge of navigating good news

You're mid-flight, several thousand metres above the ocean of your choice. The captain comes on over the plane's speaker to announce:

"Great news, everybody. We're finally handing over to a pilot who really knows what they're doing."

I'm sure your cool head will win out. You'll process the news rationally, logically, to reach the inevitable conclusion that this is, of course, good news. Meanwhile, the stranger next to you grabs your arm and squeals, ***"What kind of chump was flying this thing before?"***

And what does the captain expect you to do about this news? Well, there's not much you can do. They probably only told you because some pesky legislation said they have to. They've got your best interests at heart, I'm sure. Or that's what they'd say. **DO YOU TRUST THEM?** How do you explain things to your panicky neighbour?

This is the problem with a buy-out. It should be good news. But unless you're careful it won't feel that way. People assume any news about their pension is bad news. Just like the passengers on that flight, members will feel unnerved, perhaps suspicious… certainly confused. A few will even feel betrayed – in their eyes, you promised to take care of them and now you're dumping them. And the more you try to insist it's good news, the more it undermines your credibility.

HOW YOU TALK TO MEMBERS AFFECTS WHAT THEY DO – AND THE VALUE OF THE SCHEME

On a plane I doubt you'd have many rushing for the parachutes because of a fluffed announcement. In a pension scheme the equivalent "escape" is transferring out. And that, unfortunately, is more tempting than the leap to the water. So if they don't trust the crew, people will jump. And that's before you take account of the sharks.

But unlike other comms challenges, this is one you can see coming. You're planning for it. So when you're planning your buy-out strategy, plan your comms. It will all go more smoothly if you do, especially if in the run-up to buy-out you're operating any exercise that asks members to respond or make a decision. In the short term you'll get a better response and you'll help members make better decisions. But good comms can also help the scheme get a better deal.

There's value to an insurer if they know members have responded in good numbers to comms exercises. These are easier members to work with. Many will self-serve. You've proved that they're engaged and informed. That they won't be calling up the helpline when they're spooked by a headline.

The comms leading up to a buy-out are your opportunity to do two things:

SHAPE YOUR STORY AND BUILD **TRUST** WITH YOUR MEMBERS.

SHAPE YOUR STORY

As soon as you arrange information into an order. As soon as you say, "Because of that, we're doing this…" As soon as you try to describe or explain change. Whether you like it or not, you're telling a story.

The story is the result of the decisions you make about what you say and what order you say it in. And, of course, what you don't say. Not everybody needs to come out of this an expert in the technicalities of planning and executing a buy-out. In fact, nobody does.

We are an industry mesmerised and often paralysed by process. And from that process-focused crowd, who's risen above the rest to handle the most "process-iest" of processes? You. Congratulations. There will be problems you have to solve. Steps you have to take. Many of them will keep you occupied for many, many hours. They will grow on you, fascinate you, even excite you. So how do you explain these things to the outside world? You don't. The space you give something in your comms should not reflect the time you've spent on it. In fact, the relationship should almost always be inversely proportional. If something took you a long time to get right, you probably barely need to mention it, however brilliant your solution.

Goals and obstacles. Desires, frustrations and triumphs. These are the building blocks of story – not process. Oh, and it's your members' goals, desires and triumphs – not yours.

When your airline sells you that seat, it's the destination that entices. The sun-kissed palm or the powdered piste. Not the route, the altitude or the torque in the turbines. You trust them to get you there.

So talk about why all this matters. Early on, set up where you're all heading, together. Be open about the steps between here and there. Open, but not in the way a mechanic would open a bonnet.

BUILD TRUST

There is no other context in a member's life in which "wind-up" is a good thing. We're used to this kind of language, but to the rest of the world it's confusing and scary.

Most schemes want to "bust" jargon. And that's fine. But your glossary of technical terms won't nudge the needle when it comes to members' instinctive responses. Before they get the chance to understand what you're saying they'll feel powerless. Beware a member who feels powerless: they'll take action just to be doing something, even if it's not in their best interests.

Members need to trust you. They need to feel like you will never let them down. It's this, and not a good definition of a "bulk annuity", that will help them make good decisions. It's this that will protect them from scammers.

Your communication is your means of building that relationship – your choice of channels, how often you're in touch, how consistent and reliable you are, how much you tailor each message to each audience, right down to the individual words and images you use.

So if you want to bust jargon, bravo. Even better if you can talk in a way that gets rid of jargon completely. No busting required.

If you want quick fixes to make your language clear, reassuring and trusted, some small changes will make a big impact: use verbs instead of nouns, especially abstract nouns. ("Preparation for transaction"? Or, "getting ready to sign on the dotted line"?) Turn passive sentences into active ones. ("Once a policy has been issued…"? Or, "once the insurer issues your policy…"?) It's not only clearer, it forces you to put people in. The instant human touch.

If you want comms "secrets" borrowed from the dark arts of behavioural economics, take your pick: use white envelopes, not brown. Use a clear address window that's slightly misaligned (for that tantalising glimpse of what might be inside). Use the word "you" a lot and include a picture of a smiling person – preferably the same gender and race as the member you're writing to.

But really, you're playing with smoke and mirrors unless the foundation of your communication strategy is the trust of your members. Your priorities are their priorities. You know what they're interested in and the language they use to talk about it. How? Because your communication goes both ways. Trust demands that. Listen to your members.

When you plan your comms, what image do you have of you and your members? Are you standing opposite each other, with a countertop between you? Are you sliding them forms and small print? Serving. Transacting. Or are you standing alongside a member – an individual – looking out together at ***their future, their life*** beyond retirement, talking about ***how they feel?*** And listening to what they have to say.

JOE CRAIG
Quietroom

Joe's worked on communications strategy for pension schemes big and small, particularly those facing changes and challenges. His expertise is in using language and story to keep people interested in reading something they wouldn't normally want to read. He's the best-selling author of 15 books.

Implementing the monthly process

"The monthly process is often more complex than it looks on first glance and each scheme works differently, however the objective is the same for them all – making sure members are paid on time!"

Laura has been part of the Transition Management team at Rothesay Life since 2016, working closely with trustees and their administrators to facilitate multiple buy-in and buy-out transactions. Tullett Prebon, Toshiba, Allied Domecq and telent are among the schemes Laura has worked with.

LAURA RUSSELL
Rothesay Life

Whether a trustee has chosen to secure the future of a scheme with a buy-in or a buy-out, for both types of transaction there will be a buy-in phase and payments to members are paid via the trustee.

(i.e. the insurer will make payment to the trustee who will then pay the member).

In advance of signing a bulk annuity contract with Rothesay Life, and to ensure this process works seamlessly, our transition team will arrange a visit to the trustee's administrator to explain how the new arrangement will impact on their current processes and what changes will be required. This meeting will ensure that the administrator is comfortable with the processes that are about to be agreed in the policy documentation and that they have the ability to implement these processes in practice.

THE PROCESS

The monthly process is often more complex than it looks on first glance and each scheme works differently, however the objective is the same for them all – making sure members are paid on time!

During the buy-in phase there are a number of different ways that Rothesay may agree to make payment to the trustee account each month:

Fixed payroll – a fixed monthly payment amount has been agreed in the policy documentation either for the monthly payroll alone, or for the payroll and the estimated commutation lump sums (ELS).

Pull payroll – the trustee administrator supplies Rothesay's administration team with a payroll extract each month. Rothesay arranges the monthly payment amount in accordance with that extract. The trustee "pulls" what they need.

Push payroll – Rothesay calculates the monthly payment amount based on the insured population and the reported movements for the month. The trustee is "pushed" what they are owed under the contract.

In order to calculate the correct payment to make each month Rothesay will require regular information from the schemes administrators.

Movement reporting – the trustee administrator will provide details of member status changes made in the previous month, in a prescribed format, ahead of the monthly payment date each month.

Lump sums – in each scenario above (except where ELS amount has been fixed), the trustee administrator supplies a list of lump sum amounts due for payment by the trustee that month along with pdf copies of settlement papers (unless agreed otherwise). Rothesay Life arranges payment of the lump sums having checked the application of the correct factors.

Payroll adjustments – the trustee administrator will report on any payments returned to the trustee account relating overpayments (often related to late notification of death), returned BACS and any payments made outside of the payroll (e.g. back payments being made to any suspended members who need reinstating) to Rothesay's administration team.

Cashflow reconciliation – in the pull payroll scenario, Rothesay will complete a reconciliation of payments made to the trustee during the buy-in period, and calculate a true-up adjustment.

THE TIMING

The monthly payment date is agreed in the policy documentation, and is usually two to three business days ahead of the date the scheme members are paid on by the trustee.

There is often a cashflow reconciliation of the payments due/paid at the end of a specified period (usually following receipt of a cleansed data file on completion of an agreed list of data cleanse activities) particularly where the pull payroll method has been operating whilst the trustee administrator completes data cleanse activities.

THE DETAIL

Rothesay uses a secure electronic file transfer site (SEFT) to send and receive reporting information between ourselves, our administration team and the trustee administrator.

Our administration team, overseen by the Rothesay transition manager, will review and approve payment requests and movement reports.

The Rothesay administration team will also check that data used in any commutation lump sum requests matches the original or updated cleansed data file supplied by the trustee, and will raise any immediate questions with the trustee's administrator.

The Rothesay administration team will work closely with the trustee's administrator to resolve any discrepancies and ensure that payments are made on time each month.

Movement queries with no immediate payment impact are collated into a query log and sent to the trustee administrator to investigate and respond before the next month's reporting period.

Although the format and frequency of the monthly process will have been agreed in the policy documentation, it's the relationship built between Rothesay and the trustee, including both parties' administration teams, that will be key to providing a smooth ongoing payroll service to members throughout the buy-in and eventual buy-out.

Settlement GMP equalisation

GMP equalisation post Lloyds

For many years, trustees and their advisers have adopted a pragmatic approach to GMP equalisation when winding up their pension schemes. This has ranged from those who some years ago decided to do nothing to more recent (pre-Lloyds) cases where a value based approach was adopted and one-off enhancements made to provide scheme benefit style additional pension in the future.

Sadly, since the Lloyds case, that simplified approach has been called into question (in many people's view actually curtailed completely as an alternative). The judgment appeared to offer the flexibility to convert GMPs and avoid having to re-engineer administration systems – but in the absence of any immediate guidance on how to complete GMP conversion without exposing some (senior and/or long-standing employees, therefore influential) scheme members to the possibility of significant taxation issues – we are left with the stark reality that C2 (dual administration) is the default answer at this time for many trustees who want to complete a scheme wind-up. The conversion challenge is further strengthened by the fact that many schemes will not necessarily know which members could suffer adverse tax consequences and are therefore not prepared to take an unquantified taxation risk for scheme members. For some smaller schemes, it may be feasible to collect information from scheme members to allow for conversion to be implemented without unknown tax consequences and in such cases we will be pleased to accept this approach.

"The conversion challenge is further strengthened by the fact that many schemes will not necessarily know which members could suffer adverse tax consequences..."

The dual administration approach has a number of challenges for insurers and trustees alike. All administrators are now involved in the inevitable significant overhaul of their systems and processes, and that combined with the challenges of collecting and analysing historical data (in a worst case scenario – nearly 30 years of history for an early 1990s retiree) means that in practice a fully implemented C2 solution is likely to be some years away for those schemes who are not compelled to fix the problem now. All of this work, both retrospective and future, comes at a considerable cost – it is therefore not surprising that most schemes continue to wait and hope that GMP conversion can be blessed by HMRC, even if this requires a piece of primary legislation to change the taxation rules.

For those who cannot wait, we have now offered to provide C2 administration, as soon as we are physically able to implement it (and taking into account the order of transactions we have entered into). This still requires the trustees to do the retrospective work and associated calculations in order to provide the records required to administer the benefits going forward – in many cases this will be a heavy lift as records may not be readily available and may therefore need to be reconstructed using modelling and historical scheme-wide information. There seems to be no obvious reason why this part of the work shouldn't progress for all schemes on their settlement journey – even if we are all fortunate enough to find a way through the conversion tax issues, the past underpayments need to be calculated and settled before benefits are then converted for the future.

On the basis that this problem arose during the period from 1990 to 1997, it is hardly surprising that the fix is taking some time to implement – the pensions industry has, after all, tried to ignore the problem for the best part of three decades on the basis that for most scheme members the benefit improvement will be relatively insignificant compared to the costs of implementation...

JONATHAN SARKAR
Rothesay Life

Jonathan is the Chief Operating Officer at Rothesay Life, having been at the firm since 2009. He is a Fellow of the Institute of Actuaries and has been involved in all the Rothesay transactions with both pension scheme trustees and insurance companies. Before joining Rothesay, Jonathan was a board director of HSBC Actuaries where he was UK Head of Corporate Pensions Consulting and prior to that he worked at Mercer, progressing from a graduate trainee to a European partner.

Lloyds Judgment

On 26 October 2018 Mr Justice Morgan handed down judgment in Lloyds Banking Group Pensions trustees Limited v Lloyds Bank PLC & Others. The judgment confirms that formerly contracted-out pension schemes are required to equalise GMPs between males and females, and identifies which methods it considers legally robust to achieve this.

Data cleansing, premium true-ups and issuance

Whilst most schemes will have undertaken some action to get their data in shape prior to approaching the insurance market for quotations there will some areas where it may not have been possible to prepare the data fully. For example, completing any guaranteed minimum pension reconciliation exercise or finalising the collection of data on members' spouses.

"To help trustees and their scheme administrators navigate their way through this often complex process a member of Rothesay's transitions team will be assigned to the case."

These are two areas where many schemes have traditionally collected data at the point of retirement or in the event of death, or in the case of GMP reconciliations struggled to balance the sheer volume of work involved with ongoing day to day administration, but both areas where incomplete data can make a material difference to the value of liabilities. Other schemes may have started reviewing their legal documents to check for historical problems but not completed any resulting corrective actions required before seeking quotations.

During the initial quotation phase insurers are very likely to conduct their own due diligence on the data provided and may also seek to establish the legal entitlements under the scheme. They will review the benefit specifications supplied alongside the data and any scheme documentation to ensure the benefit specification effectively summarises the scheme rules and ties up with the data provided.

The outcome of the insurer's due diligence and the scheme's own preparation will often mean there are a number of data cleanse activities the trustees will be obliged to carry out under the bulk purchase annuity contract before the insurer will issue individual policies to the scheme members.

The period from when a contract is initially signed to when individual policies are issued can be anything from a few months, if the data is in good order, to many months, even years if not. During this period the data cleanse actions identified during the quotation phase need to be carried and then thoroughly checked and reviewed for completeness and accuracy. Where data was flagged as missing or incomplete, it can take time to collect and calculate, leading to delays in the transition process if sufficient resources are not made available to address these issues. To help trustees and their scheme administrators navigate their way through this often complex process a member of Rothesay's transitions team will be assigned to the case. They will work in collaboration with the project team and administration team to ensure all the required actions are carried out in accordance with the data cleanse requirements in the contract and in a timely and efficient manner.

"... and rest assured they have secured the long-term benefits of their members, a job well done"

During the process of cleansing the data it is also important that any relevant data is updated and held accurately in the core administration records and importantly, is kept up to date. For example in the case of contingent spouses pensions, this means increasing them each year at the same time as the normal pension record.

Other areas where benefits might not be reflected in the core administration data but may have been identified during the due diligence phase and therefore captured as a data cleanse action include, but are not limited to:

- pension sharing orders – which may have been seen stored in notes fields
- transferred-in benefits – which may have been stored in a similar fashion
- underpins – held outside of the core data

Working with the incumbent administration team data items, such as these, need to be transferred out of non-core fields and either into primary data fields on the administration database or into an agreed format ahead of the administration data being passed across later in the process. This activity ensures all the relevant data held by the scheme administrator is included in the full administration data extract that will be passed across to the insurer at the point the scheme is ready to transfer responsibility for the administration and payment of benefits.

Upon completion of the data cleanse exercise and the updating of the administration database the trustee will be required to submit a revised data file, as at the policy inception date, which accurately reflects the status of all members at that point in time and their correct level of benefits.

The insurer will review the revised data file and supporting benefit specification alongside the trustee's summary of all the data cleanse actions undertaken. Changes made to the data and updated membership status details will invariably lead to changes to the insured benefits and a resultant adjustment to the original premium.

Following completion of the data cleanse and settlement of any premium adjustment. The transition enters its final stages, culminating in the insurer issuing individual policy documents to the scheme members.

At this point clear and concise member communication becomes imperative as the trustee prepares to hand over responsibility for the ongoing administration of the scheme to the insurer. Members need to be informed of the benefits that are being transferred and reassured that apart from a change in contact details and the insurer becoming responsible for payment of their benefits they should see no other changes.

Where the data cleanse has resulted in member benefits being adjusted members will need to be informed of any arrears they may be due or any overpayments that the trustee may wish to clawback.

Members will expect the policy documentation issued by the insurer to lay out clearly (and accurately) the benefits that are payable. A good measure of this is that members should be able to cross reference their benefits referred to in the final trustee communication to those stated in their individual policy document. Should they be so inclined, the scheme member, now a policyholder, should also be able to accurately calculate the amount of their own increases as they fall due, or confirm what benefit would be payable in the event of their death. It is at this stage the importance of the data cleanse activities and any revisions made to the supporting benefit specification become very clear. As to have left any data "uncertainty" or allowed any potential ambiguity to exist with regards the insured benefits is not aligned to the principles underlying the Treating Customers Fairly regime and also creates the potential for many future months of queries.

Once policy documents have been issued to the scheme members the insurer will make their first payment to their new group of policyholders and the trustee will be able to focus their attentions on the final stages of winding-up the scheme and rest assured they have secured the long-term benefits of their members, a job well done.

DAN CRADOCK
Rothesay Life

Dan works as a Transition Manager at Rothesay Life and has worked in the bulk annuity market for over 10 years. Project managing client installations and developing long term client relationships Dan has been involved with all three of Rothesay's insurance transfers from Prudential, Aegon and Zurich.

Wrapping up

Chapter 5

"We were very impressed by everyone we met, they were very well organised, they were very keen to make things happen and they had a very positive attitude to dealing with all our issues. I had expected them to be very "hard-nosed" about the deal, but they weren't and that was a pleasant surprise. "Nickle and diming" did not happen, despite their American investment banking origins. There was lots of give and take between us – it was the right sort of commercial relationship."

BRIAN DUFFIN
Trustee Chair, GEC 1972 Pension Plan

Until death do us part

Selecting an insurer is somewhat like choosing a partner to marry. Bulk annuities tend not to have any provisions for divorce – they are intended to lock you together forever.

Whilst most buy-outs will reach the issuance of policies direct with members fairly quickly, some can take many years. Either way the pensioner members have no divorce option and deferred pensioners cannot switch annuity provider without loss of guaranteed pension. So it is not just about selecting an insurer with the best price and contractual terms. It is also about fit and having a good relationship both in the exclusivity period up to signing and more importantly in the many years afterwards once the policy is in place.

When Rothesay Life launched in 2007 there was a clear reluctance to transact with untested start-ups. Multi-line insurers such as Aviva and L&G have brands known to most pension scheme members and trustees naturally wanted to be able to reassure their members with a pension from a well-known firm. This preference became stronger with the global financial crisis and the start-ups either needed to be cheaper than the established players or have other clear advantages to meet a particular client need.

At Rothesay Life we came to the conclusion that in order to attract clients, we would need to:

- Lead the market in our thinking about how to solve client-specific issues
- Consistently do a very good job with and for our clients

Our aim was that over time our clients would become our advocates. From 2013 we started offering our prospective clients the ability to talk to any of our existing clients during the selection phase of a process. Most trustees have never completed a bulk annuity transaction and this gave them an opportunity to learn about the market from their peers and find out what it is like working with Rothesay Life as a bulk annuity insurer. How do they treat their clients? How do they behave once the contract is signed, the premium's paid and there's no way to reverse the insurance?

In terms of doing a good job for our clients we have focused on a number of aspects:

- We strive to ensure that we never offer to do something that we subsequently don't, won't or can't do. Delivering on what we say we will do is key to building long-term trust with clients and their advisers.
- We pay a great deal of attention to risks in all guises, not just ours as an insurer but also the risks that trustees may face or feel
- We aim to be flexible and responsive to trustee needs in negotiating contractual terms and in running the contract after signing. Every scheme is different and has nuances and needs to achieve buy-out in their particular circumstances.

Establishing a brand this way has taken time. It is now 12 years after completing our first bulk annuity and we feel like we have a strong reputation amongst market experts and leading trustees. This shows in independent surveys we have commissioned to explore client and adviser views on where we could improve, and which we have repeated at regular intervals. Some comments from recent clients are included below and opposite. For trustees and sponsors that are planning to approach the market, we would recommend doing some research to find out what it will be like to work with each of the candidate insurers in the selection period, in exclusivity, during implementation and importantly what they will be like for the members after issuance. It is after all a very long-term partnership and not a blind date.

GUY FREEMAN
Rothesay Life

"Rothesay were very professional tackling each hurdle with a problem-solving attitude, this isn't the case in my experience with their competitors."

ANDY BOORMAN
Director BESTrustees

"To be honest I find Rothesay a breath of fresh air, they are very easy to deal with and are very understanding."

STUART REVILL
International Pensions and Benefits Manager at a Financial Services client

"Rothesay have worked very well with our advisers; I have had nothing but positive feedback. I would have no hesitation in recommending Rothesay to anyone. They are thoroughly professional and keen to deliver, a good combination."

LISA ARNOLD
Trustee Chair, Allied Domecq Pension Fund

mallowstreet survey results

mallowstreet

The survey results in this publication are based on a survey of 54 pension schemes. Key statistics on the participating schemes are detailed here.

We are a members-only online community website, with a portfolio of educational in-person and digital events that sits alongside. Both the website and the events are specifically for professionals in the institutional pensions industry and are accredited by the Pensions Management Institute.

Figures shown in brackets represent the number of schemes (one respondent per scheme). Some figures may not add to the total due to rounding.

STUART BREYER
CEO

ALLY GEORGIEVA
Head of Insights

"mallowstreet's mission is to empower every pension fund to make better decisions, meaning every person can have a better retirement."

BY ASSET SIZE

>£10bn	**15%** (8)
£3-10bn	**17%** (9)
£1-3bn	**30%** (16)
£200m-£1bn	**18%** (10)
<£200m	**20%** (11)

BY JOB ROLE

Trustee Director/Chair	**28%** (15)
Trustee	**24%** (13)
Investment roles	**19%** (10)
Independent trustee	**9%** (5)
Pensions Director	**7%** (4)
Pensions Manager	**7%** (4)
Pensions Secretary	**6%** (3)

BY SECTOR

Finance/Banking	**24%** (13)
Government	**6%** (3)
Information technology	**6%** (3)
Healthcare	**4%** (2)
Manufacturing	**13%** (7)
Transport/Logistics	**7%** (4)
Wholesale/Retail	**9%** (5)
Other	**31%** (17)

BY COVENANT STRENGTH

Strong	**41%** (22)
Tending to strong	**37%** (20)
Tending to weak	**15%** (8)
Weak	**7%** (4)

BY FUNDING LEVEL ON BUY-OUT BASIS

>90%	**31%** (17)
80-90%	**31%** (17)
<80%	**33%** (18)
Does not apply*	**4%** (2)

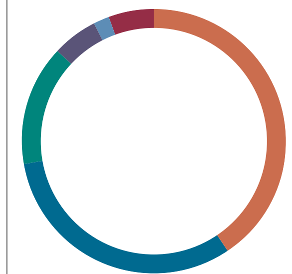
*e.g. LGPS schemes or working towards self-sufficiency.

BY DISCOUNT RATE USED FOR BUY-OUT BASIS

Gilts plus 26-50 bps	**11%** (6)
Gilts plus 1-25 bps	**26%** (14)
Gilts flat	**28%** (15)
Gilts minus 1-25 bps	**11%** (6)
Gilts minus 26-50 bps	**4%** (2)
Other*	**9%** (5)
Do not know	**11%** (6)

*e.g. better of gilts and swaps, blended rate based on observed pricing for different liabilities, no discount rate on buy-out basis – technical provisions basis only.

BY ENDGAME



Buy-out	**41%** (22)
Self-sufficiency	**31%** (17)
Undecided	**15%** (8)
Merger	**6%** (3)
Consolidation	**2%** (1)
Does not apply*	**6%** (3)

*e.g. LGPS schemes or did not wish to disclose.

BY TIME TO ENDGAME

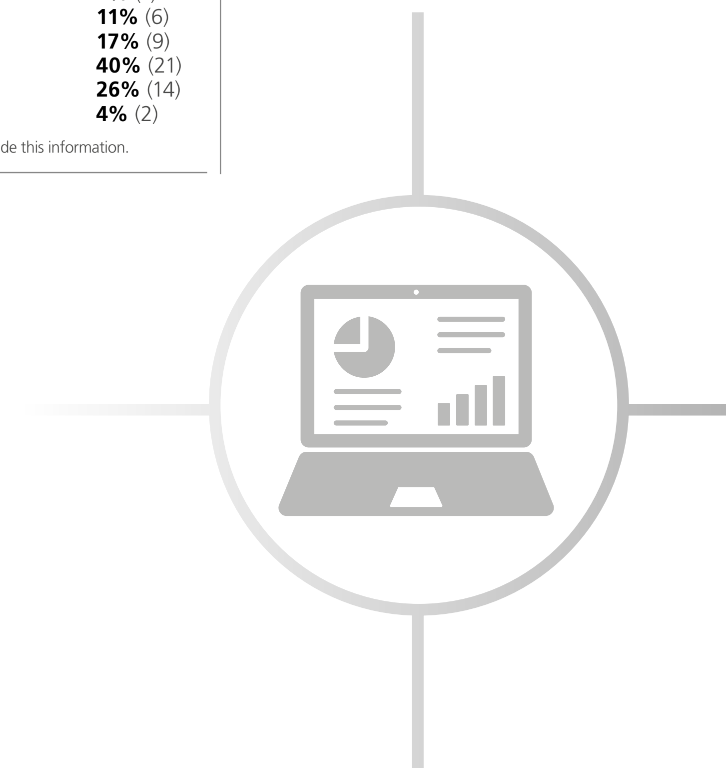
<1 year	**2%** (1)
<2 years	**11%** (6)
<5 years	**17%** (9)
<10 years	**40%** (21)
<15 years	**26%** (14)
Longer	**4%** (2)

Note: one scheme did not provide this information.

BY PERCENTAGE OF NON-PENSIONERS

<20%	**4%** (2)
<30%	**2%** (1)
<40%	**11%** (5)
<50%	**9%** (4)
<60%	**18%** (8)
<70%	**11%** (5)
<80%	**13%** (6)
<90%	**20%** (9)
<100%	**11%** (5)

Note: Based on Pension Funds Online information, where it was available at time of writing



Jargon Buster

Specialists in any topic tend to develop their own terms to describe the various aspects and operation of their market. To aid the reader of this and other reports on the market the pensions team at Linklaters has put together a summary of some key terms used in buy-in, buy-out and longevity transactions. Terms in ***bold and italics*** are defined terms.

Term	Explanation
All-risks	All-risks refers to a ***bulk annuity*** insurance policy which covers residual risks that a ***buy-in*** or ***buy-out*** would not normally cover i.e. potential liabilities outside of the core benefits. They vary in the scope of their cover and are often called ***residual risk*** policies (because they don't cover all risks in a literal sense).
Balancing Premium	This is the balancing amount which is payable under a ***buy-in*** to the Trustee or to the insurer once the ***data cleanse*** has been completed. Also called a ***premium adjustment***.
Benefit specification	This document summarises all the benefits which are going to be insured by the insurer under the ***buy-in*** or ***longevity swap***. It will also capture discretions and practices (for example in relation pensions payable where there is financial dependency) and may look to codify these.
Benefits mismatch	This is where the benefits insured by the insurer do not exactly match those provided under the scheme.
Best estimate of liabilities/ BEL	The "best estimate of liabilities" is an insurer's best estimate of the net liabilities that it will have to pay out over the life of an insurance contract or group of insurance contracts. The ***termination payment*** (if any) in a ***buy-in*** or ***buy-out*** contract is often linked to the best estimate of the liabilities at the time of termination.
BoE	The Bank of England
Bulk annuity/Bulk purchase annuity/BPA	A bulk annuity or a bulk purchase annuity is an insurance policy taken out by the Trustee. The insurance policy is in the Trustee's name and is an asset of the scheme. The insurer will make scheduled payments under the policy to match the Trustee's insured liabilities. The Trustee and its administrator continue to operate the scheme as usual but are funded by payments under the insurance policy. Members do not have direct rights against the insurer.
Business as usual	Standard operations or procedures relevant to a particular entity.
Buy-in	A buy-in is a ***bulk annuity*** policy that is held by the Trustee. This can either be held for the long term or simply just for the period of time before moving to ***buy-out***. A buy-in will always precede a ***buy-out***. This is because the first step in buying-out will always be a ***bulk annuity*** policy with the Trustee (the buy-in policy) before the insurer issues individual policies for beneficiaries which achieves the ***buy-out***.
Buy-in price or Initial premium	The initial amount which the Trustee will pay to the insurer on signing the ***buy-in*** policy to go ***on-risk***. Subject to adjustment as part of the ***data cleanse***.

Term	Explanation
Buy-out	A buy-out refers to the process where the insurer steps into the shoes of the Trustee, and issues individual policies directly to scheme members. The members' benefits are then provided directly by the insurer and members have direct rights against the insurer. The Trustee is discharged from liability in respect of those benefits it has bought out. If all benefits are bought out, the scheme usually winds up. A ***buy-in*** will precede ***buy-out***. A ***buy-in*** that is intended to move to ***buy-out*** is often called a ***buy-out***.
Collateral	Collateral refers to a pool of assets held as security in return for an insurer's obligations under the insurance policy. If the insurer goes insolvent, or if certain triggers occur, the Trustee can have recourse to those assets. If a transaction is "collateralised" this means that there is collateral being held. The collateral is usually held by a separate custodian. There is no obligation to have collateral and most ***buy-ins*** do not.
Consolidator/Superfunds	The consolidators or "Superfunds" are occupational pension schemes that are set up "for profit". A consolidator will take on the assets and liabilities of other defined benefit pension schemes by way of a bulk transfer. It is a single employer scheme with no link to the transferring pension scheme (or its sponsoring employers). No benefits are built up whilst in the consolidator's scheme. The scheme will include a capital buffer which sits outside the scheme.
Coverage/cover	The insurer will only insure the benefits and risks the Trustee asks them to, and what they insure is the "coverage". Therefore, any liabilities outside the scope of the coverage described in the contract or the ***benefit specification*** will not be insured and the Trustee will have to meet these from scheme assets. Whether or not a certain risk (for example GMP equalisation) is covered will be a matter of negotiation and may be subject to the payment of an additional premium.
Data cleanse (often also referred to as verification)	This is a process where the administrator will cross-check and verify certain data they hold for the members of the scheme (usually referred to as the ***Initial Data***) for the purposes of ***the buy-in***. For example, this may involve checking members are still alive; whether their date of birth is correct; and whether their sex is correct. This is often referred to as verification. The data cleanse will likely be followed by a ***Balancing Premium*** also known as a ***Premium Adjustment***. This can be a complex and lengthy process and can be carried out in advance of a de-risking project, or after the transaction has been entered into and before buy-out. The aim is to make sure the data is as accurate and complete as possible.
Dis-intermediated structure	Some ***longevity swaps*** are structured this way. The insurer accepts limited liability and acts as a "pass through" or go-between and the Trustee contracts with the ***reinsurer*** as much as possible. Also referred to as a pass through structure.
Due diligence	The insurer or reinsurer will usually undertake some form of review before a ***buy-in*** or ***longevity swap***. This is checking the scheme, its operations and its data to check they are happy to enter into a contract with the Trustee and to identify any issues they have.
Exclusivity	Where the Trustee agrees to only negotiate with a certain insurer for a possible transaction. It will usually last for a limited time. There is no obligation to transact at the end of it. Exclusivity may be documented in an exclusivity letter and is often provided as part of the insurer agreeing to a ***price lock***.
Experience data	The data the Trustee holds about the deaths within the scheme.
FCA	The Financial Conduct Authority.
Finalised Data File/Verified Data	This is the member data post-***data cleanse/verification*** (i.e. it has been checked, errors corrected) and the insurer and the Trustee have agreed that this is the final form data. There is often a ***balancing premium*** to pay once the final data has been agreed.
FSCS/Financial Services Compensation Scheme	This is the Financial Services Compensation Scheme, which is a scheme that compensates holders of insurance policies if the insurer goes insolvent, subject to certain conditions.

Term	Explanation
Fully-intermediated Longevity swap	Some ***longevity swaps*** are structured this way. The Trustee enters into an insurance policy under which the insurer takes on full liability to the Trustee. The Trustee has no visibility over the insurer's own hedging arrangements.
Gap policy	This relates to the insurer's ***matching adjustment requirements***. If an insurer wants to place the assets held under the Trustee's ***bulk annuity*** policy into its ***matching adjustment portfolio***, the policy has to comply with certain terms. If a term or payment (for example, payment on termination of the policy) does not comply with the ***matching adjustment requirements***, the insurer may request this is covered by a separate policy (known as a gap policy) so as to avoid invalidating the whole ***buy-in*** contract from qualifying for ***matching adjustment***. This gap policy is just a separate insurance policy, which is not eligible for ***matching adjustment***.
Implementation	After the buy-in is executed, the operational aspects of the buy-in are put in place.
Inception	The date the policy is effective and the insurer goes ***on-risk*** for the benefits.
Individual annuity/policy	These are the insurance policies issued by the insurer on a ***buy-out*** in the name of each scheme member entitling them to benefits equivalent to their rights under the scheme. The Trustee and scheme cease to be liable to the member.
Individual surrenders (i.e. CETVs)	Where a member or beneficiary surrenders or commutes their benefits instead of receiving benefits from the scheme or insurance policy. Common examples are a cash equivalent transfer value (CETV) or a trivial commutation lump sum.
Initial Data File/Initial Data	This is the spreadsheet, or other file, containing the key data for payment of members' benefits (i.e. names, NI numbers, dates of birth, pension in payment). This is normally provided right at the start of the transaction, and then once the documents are signed the ***data cleanse/verification*** period begins. The ***initial premium*** (i.e. the price the Trustee pays at the start of the transaction) is based on the Initial Data.
Initial Period	The period under the contract before the ***Finalised Data File*** is confirmed.
Insurer factors	These are the factors the insurer uses to calculate benefits such as reduction to pension for early payment or the factors used when pension is being commuted for tax-free cash. These are usually different to the Trustee's scheme specific factors.
ITQ/RFP	Invitation to quote or request for proposal: This is essentially a tender which goes out at the start of the process to insurers, who will return their price on the basis of that document. It is usually accompanied by the ***benefit specification***.
Joint working group	This can be a working group set up by the Trustee with or without the scheme sponsor and is used as part of managing entering into a ***buy-in***, ***buy-out*** or ***longevity swap***.
Longevity	How long members live for.
Longevity swap	An insurance policy similar to a ***buy-in*** but the only risk the insurance policy covers is longevity. It covers the risk of members living longer than expected. The survival of dependants is usually covered as well.
Longevity swap novation/ conversion	This is where a ***longevity swap*** is turned into a ***buy-in*** with the reinsurer counterparty in the ***longevity swap*** providing the reinsurance to the ***buy-in*** insurer.
Marital status data	This is data that confirms the member's marital status that can be useful for insurers and reinsurers when pricing a transaction.
Marital status survey	A survey a Trustee may undertake of its members to get details of members' marital status. This can be useful for insurers and reinsurers when pricing a transaction.

Term	Explanation
Matching Adjustment/ MA/ Matching Adjustment Portfolio	How much capital an insurer has to hold is determined in part by the value of its liabilities. Insurers value the present value of their liabilities using a discount rate. A ***matching adjustment*** is an upward adjustment to the discount rate, which has the effect of reducing the amount of liabilities and therefore also the insurer's ***Solvency II capital requirements***. An insurer can only use a ***matching adjustment*** where it meets certain conditions and has a ***matching adjustment portfolio***. When an insurer has a ***matching adjustment portfolio***, this means that it sets aside a portfolio of assets to support a known/predictable portion of their liabilities. The return on the assets in the ***matching adjustment portfolio*** match the liabilities attributable to that portfolio – i.e. the assets match that proportion of liabilities, and so the overall risk is reduced, and the insurer is able to use ***matching adjustment*** to reduce its ***Solvency II capital requirements***. An insurer may put a ***bulk annuity*** contract into a ***matching adjustment portfolio***, which means that the contract needs to comply with the ***matching adjustment*** requirements. If a term is non-compliant, it may be put into a ***gap policy***.
Material change	This is where as a result of the ***data cleanse*** there is a large change in the data and can lead to the insurer being able to re-price the transaction or in some circumstances even terminate if the change is large enough.
Minimum capital requirement	This is the absolute minimum level of capital that insurers can hold without losing their licence. As described below, ***Solvency II*** requires a level of capital high above that minimum.
Missing beneficiaries	Members of the scheme that the Trustee does not know about.
Mortality Risk	The risk that a person dies. Where insurers have provided life cover that pays out on death they often ***reinsure*** this mortality risk in the life ***reinsurance*** market. When the same ***reinsurers*** also insure ***longevity risk*** for pension schemes or ***bulk annuity*** insurers, the two risks can offset and reduce the capital requirements for the ***reinsurer***.
Non-disclosure Agreement	This is put in place when the Trustee wants to pass scheme (including member) data to the insurer so the insurer can quote a price. This governs the insurer's use of that data and includes protections for the Trustee.
On risk	The point in time at which the insurer becomes liable under the ***buy-in*** or ***longevity swap*** in respect of the insured benefits (and goes "on risk").
Part VII Transfer	This is a court-approved regulatory process for an insurer to transfer some or all of their business to another insurer. The process is overseen by the court, the ***PRA*** and the ***FCA***, and an independent expert is appointed to consider the impact of the transfer on policyholders, including any Trustee who holds an insurance policy.
PPF+ Buy-out	This is a ***buy-out*** where benefits are secured at a level below full scheme benefits but greater than PPF compensation. This is usually done either following the sponsor's insolvency (where the scheme is funded above PPF levels) or as part of a restructuring to allow the survival of the sponsor (such as a regulated apportionment arrangement).
PRA	The Prudential Regulation Authority.
Premium adjustment	This is where the premium paid by the Trustee to enter into the ***buy-in*** may change. This is often because of a ***true-up*** due. This is also called a ***Balancing Premium***.

Term	Explanation
Price lock/gilt lock/ price-lock portfolio/asset lock	At the outset of the transaction, the insurer's pricing terms may be agreed relative to market conditions. Therefore, over time, the exact amount of the premium moves in line with market conditions or the insurer's investment strategy. This leads to a risk that the premium moves so much that the Trustee can no longer afford it. In order to pay the premium, the Trustee will usually set aside cash and assets (i.e. shares, bonds, gilts) to fund the premium. Under a "Price-Lock Portfolio" the insurer agrees that their premium will be tracked in line with a portfolio of identifiable assets usually gilts but often also including corporate bonds and swaps. If it is entirely made up of gilts then it is called a gilt lock. This means that the Trustee can make sure the movement in their assets matches the movement in the premium. Where the Price-Lock Portfolio matches assets held by the Trustee then it is often called an Asset Lock. The "price lock" is usually agreed at the outset of ***exclusivity***.
Pull admin payroll	This is the payroll mechanism provided for in the ***buy-in*** where the Trustee calculates the amount due for each payroll and informs the insurer of the amount payable to the Trustee.
Push admin payroll	This is the payroll mechanism provided for in the ***buy-in*** where the insurer calculates and pays the amount due for each payroll.
Query log	As part of the insurer or reinsurer's ***due diligence***, they may ask certain questions about the scheme's data and benefits. The queries and answers will be recorded in the query log.
Reinsurer/reinsurance	The insurer with whom the Trustee transacts may itself insure some of its liabilities with another insurer, called a reinsurer. The reinsurer will not be involved with the Trustee in the ***buy-in*** or ***buy-out*** transaction as they do not have the right regulatory permissions to deal with the Trustee directly. The insurer may have restrictions on its ability to insure certain benefits if it cannot obtain reinsurance in the market. The Trustee may have more interaction with the reinsurer under a ***longevity swap*** depending on the structure.
Residual risks	These are types of risk outside of the core benefits that a ***buy-in*** or ***buy-out*** would not normally cover, for example, the risk of ***missing beneficiaries*** within the scheme or that the benefits provided are incorrect. A policy that covers residual risks is sometimes called an ***All-Risks*** policy even though this is a misnomer as it doesn't cover all possible risks.
Risk margin	Risk margin is an amount in addition to the ***best estimate of liabilities*** that is designed to represent the additional cost of getting a willing insurer to take over the liabilities. It acts to increase the capital that the insurer is required to hold and is calculated in accordance with ***Solvency II***.
Run-off cover	This is insurance cover the Trustee can take out on winding up the scheme which covers risks not covered by the ***buy-out***, ***all-risks*** or ***residual risks cover***. Examples of the cover provided includes cover for costs in defending any claims that may be brought against the Trustee. It is usually provided by the general insurance market and is separate from the ***bulk annuity*** policy.
SEFT site	A site which allows for secure transfer of data electronically. This is often used to provide the insurer or reinsurer access to the scheme's data in a transaction and ensure the data is protected.
Selection risks, anti-selection	The risk where one party uses information the other does not have to its advantage. For example, if the Trustee had done a medical questionnaire of its membership and knew that the health of the members it was choosing to insure was above average and the insurer is not aware of this.
Single premium	This is where the ***Initial Premium*** is the only premium due and no ***Balancing Premium*** will be payable.
Solvency II	Solvency II is an EU directive which regulates how insurers can carry out their business. It imposes ***Solvency II capital requirements*** on insurers, so that they can withstand economic and other shocks. The requirements of ***Solvency II*** are linked to the amount of an insurer's liabilities.

Term	Explanation
Solvency II capital requirements/SCR/ Regulatory Capital/reserves	Under ***Solvency II***, insurers have to hold sufficient capital to withstand a "1 in 200" shock event – i.e. enough capital so that there is at least a 99.5% chance that they will be able to meet their liabilities over the next 12 months.
Statutory discharge	Pensions legislation provides a statutory discharge to trustees who buy-out benefits in accordance with the legislation. The discharge will provide protection to the Trustee in respect of the benefits bought out.
Termination	This is where the ***buy-in*** or ***longevity swap*** is terminated if certain events occur. Different parties may have different rights on when to terminate. On termination an amount will become due from one party to the other. The amount and who it is owed to depends on the circumstances of the termination and the terms agreed.
Termination Payment	Also referred to as the cancellation payment, this is the amount which will be paid if the policy terminates (if there are termination rights). The amount often depends on whether the termination was the fault of the Trustee or the insurer, and often has a relationship to ***BEL***.
Tracing	This is a process to check whether pensioners and beneficiaries receiving pensions from the scheme are still alive or to identify correct contact details.
Transition team	The team at the insurer who will help the scheme establish the ***buy-in***, complete the ***data cleanse*** and then move from ***buy-in*** to ***buy-out***.
Trapped surplus	This is a surplus in the scheme (i.e. scheme assets exceed its liabilities) which the employer cannot access. It can be caused by the sponsor making additional funding to facilitate a ***bulk annuity*** transaction in circumstances where the additional funding turns out to have been unnecessary.
True-Up	This forms part of the ***balancing premium/premium adjustment*** and represents the difference in the benefits which have been paid during the data cleanse from what should have been paid in light of the ***Finalised Data File***.
Vendor due diligence	This is any review that the Trustee may do of the scheme, its data and processes in preparation for a transaction. The Trustee may choose to share the results with the insurer or reinsurer, usually on a non-reliance basis.
Warranties	These are various statements each party will make in the contract giving the other party assurances that a particular statement of fact is true. This can include warranties from the Trustee about the scheme's data that has been provided to the insurer or reinsurer for pricing purposes.

SARAH PARKIN
Linklaters

Sarah is a Managing Associate in Linklaters' pensions team and has specialised in pensions law for over 13 years. Sarah advises trustees and corporates on all main areas of pensions law with a focus on buy-ins, buy-outs and longevity swaps. Sarah spoke at the PLSA Investment Conference in March 2020 on "Pension Scheme De-risking".

PHIL GOSS
Linklaters

Phil is a Partner in Linklaters' pensions team with significant experience advising trustees and corporates on all areas of pensions law. He has a wide range of experience on de-risking buy-in and buy-out transactions and on liability management projects such as Pension Increase Exchange (PIE) and Enhanced Transfer Value (ETV) exercises.

Between them Phil and Sarah have worked on the following recent de-risking transactions: Allied Domecq Pension Fund (£3.8bn buy-in with Rothesay Life); Marks and Spencer Pension Scheme (4 transactions with 3 insurers totalling c.£2.8bn of liabilities); Aviva Staff Pension Scheme (£1.7bn buy-in with Aviva Life); 3i Group Pension Plan (£650m buy-in with Legal & General) and Co-operative Pension Scheme (3 transactions with 2 insurers totalling c.£2.4bn of liabilities).

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