The journey continues...

THE JOURNEY TO BUY-OUT 2022

THEN & NOW

Rothesay

Welcome to our third publication focused on the "Journey to buy-out".

De-risking remains an important focus for pension schemes and the bulk annuity market continues to be a busy hub of activity. In 2021, nearly £30bn of liabilities transferred across to insurers. Similar to recent years, we expect levels in excess of £30bn to be achieved in 2022, however what looks different this year is the wave of demand that we see coming, just off shore.

THE JOURNEY TO BUY-OUT 2022

INTRODUCTION

Many schemes experienced significant funding gains in the first half of 2022 and are now trying to lock in security for their members. These schemes may have thought buy-out was five to ten years away, however they have found themselves in a position where their funding has improved to a level which means they can afford to secure their liabilities now, much sooner than they'd anticipated.

In February 2022, Russia invaded Ukraine, sending the world into turmoil once again. The restrictions on oil and gas from Russia caused a surge in the price of fuel across the world. Inflation rose to the highest level seen in 40 years; in July 2022 RPI was 12.3% which coincided with the Bank of England discussing quantitative tightening and the biggest rise in interest rates seen since 1995. The geo-political outlook remains uncertain and as a result, volatility in the financial markets is likely to continue for now.

The rise in interest rates and ongoing market volatility has benefited many defined benefit schemes, particularly those who are not fully hedged on interest rates. Inflation has also played a part; pension increases set with reference to inflation are usually capped (e.g. at 5%), whereas the inflation-linked assets used to back these liabilities are likely to be uncapped, resulting in assets growing more than liabilities in this period of high inflation. As well as this, the impact of COVID-19 can now be seen in insurer and reinsurer pricing. This has been driven by a change in future mortality projections in the short term due to endemic COVID-19, as well as increasingly challenging conditions in the health and social care sectors.

In the coming years, insurers and consultants will be stretched to capacity as an increasing number of schemes find themselves in a position where they can afford to buy-out. The advice and tips that can be found throughout all three of our publications will be important to achieve the best results for your scheme.

Over the course of the last year, we have listened to you and the questions you have asked: this has been the foundation of our publication. We hope we have captured topics that are of interest to you and provide further insights that will benefit you and your scheme when considering your endgame plan. The collection of articles in this year's publication includes areas which we increasingly see schemes needing to address due to the current economic climate, as well as addressing common myths that we often hear discussed. A few of the authors have taken a deep dive into mortality assumptions and setting a long-term improvement assumption. Others have reflected on how far the bulk annuity market has come in the last 15 years, including key transactions and milestones. We have also taken a look forward, what the future may hold for the bulk annuity market and how the marketplace might change.

Understanding the jargon

The bulk annuity market comes with a bewildering amount of jargon. As before we have again included (and updated) a glossary of terms at the back of this publication.

mallowstreet survey results

For the third year in a row, we have carried out a survey with our friends at mallowstreet, surveying 69 pension schemes, and have shared the results with you on pages 82-95. De-risking and data preparation remain key priorities for most schemes; the survey also shows that 48% of schemes targeting buy-out now expect to achieve this in less than 5 years' time.

Contact us

We have really enjoyed meeting with many of you face to face over the course of 2022 and hope to continue to do so in the coming year.

We hope you enjoy the contents of this publication. Please don't hesitate to reach out if you have any questions or if you would like to discuss your scheme further with us. Our contact details can be found on page 104.

Thank you

I have really enjoyed creating these publications over the last few years. What began as an idea to produce a small booklet on the buy-out market has turned into over 300 pages of market knowledge, guidance, tips and much more. Thank you to all the people who have contributed and made these publications such a success. I hope you enjoy our third edition and I look forward to meeting with lots of you over the coming year.

Róisín O'Shea, Rothesay

THE JOURNEY TO BUY-OUT 2022

INTRODUCTION 01

HISTORY OF THE BULK ANNUITY MARKET: A 15 year story 04

15 YEARS OF PENSION SCHEME RISK TRANSFER
by James Mullins, Hymans Robertson 08

THE LANDSCAPE OF THE BULK ANNUITY MARKET
by Stephen Purves, XPS Pensions Group 10

MYTHS OF THE MARKET: The market is evolving at a rapid pace, and some things that may have been said in the past no longer apply to the market today. Over the next few articles, we look at some of these areas and what is true of today's market

MYTH: ALL RISK OR RESIDUAL RISK
by Sara Chambers, Gowling WLG

MYTH: TOO BIG FOR BUY-INS
by Clive Wellsteed, Lane Clark & Peacock

MYTH: DEFERRED PRICING IS EXPENSIVE – INSURERS CAN'T REINSURE IT
by Rosie Fantom, Barnett Waddingham 12

SELF-SUFFICIENCY VS BUY-OUT
by Greg Robertson, WTW 22

CO_2: Estimation & comparison of carbon emissions
by David Land, Rothesay 26

MORTALITY: Changing the long-term assumption

WHAT IS IT?
by Mark Cooper, Rothesay

HOW DO YOU SET IT?
by Stephen Courquin, RGA

WHEN DOES IT CHANGE?
by Matthew Fletcher, Aon

A GLOBAL PROSPECTIVE
by Andrew Hunt, Pacific Life Re 30

COVID-19 AND THE SWAP MARKET: What does the future look like?
by Jay Wang, MetLife 40

RESIDUAL RISK – THE HEAVY LIFT: What's involved in completing the due diligence?
by Tom Seecharan, Rothesay 44

LEGACY PHASED BUY-INS – APPROACHING A FINAL TRANSACTION: What should you be thinking about?
by John Baines, Aon 48

ILLIQUID ASSETS AND DEFERRED PREMIUMS
by Emma Hudson, Isio 52

TAX ISSUES ON BUY-OUT
by Rachel Uttley, Addleshaw Goddard 56

CONSOLIDATION IS A GOOD THING – ISN'T IT?
by David Fairs, the Pensions Regulator 62

A HIGH INFLATION MARKET: What this means for pension schemes
by Sammy Cooper-Smith, Rothesay 66

A TRUSTEE PERSPECTIVE: Six questions on endgame planning
by Tiziana Perrella, Nadeem Ladha, Akash Rooprai 70

WINDING-UP LUMP SUMS: A Trustee's parting gift
by Shona Davies, Rothesay 78

AN UPDATE ON OUR SURVEY WITH MALLOWSTREET
by mallowstreet 82

JARGON BUSTER
by Linklaters 96

CONTACT US 104

BULK ANNUITY MARKET TIMELINE

A HISTORY OF THE BULK ANNUITY MARKET

2005

The Pensions Regulator (TPR) and Pension Protection Fund (PPF) are formed and new funding regulations for defined benefit pension schemes come into force

2006-07

Rothesay, PIC, Lucida and Paternoster enter the bulk annuity market
Other active insurers included L&G, Prudential, Aviva and Metlife

2007

First pensioner buy-ins

£800m
for P&O with Paternoster

£100m
for Hunting with Paternoster

2008

Rank Group completes first large full scheme buy-out

£700m
with Rothesay

Cable & Wireless completes first

£1bn+
pensioner buy-in with Prudential

Thorn completes first

£1bn+
buy-out with PIC

2009

RSA completes

£1.9bn
longevity and asset swap with Rothesay

2010

Largest longevity swap to date for BMW

£3bn
with Abbey Life

2011

Two large PPF+ buy-outs

£1.1bn
for Turner & Newall with L&G

£830m
for Uniq with Rothesay

2014

ICI enters into two pensioner buy-ins totalling

£3.6bn
comprising the largest buy-in to date

The scheme subsequently enters into a series of buy-ins with a panel of three insurers

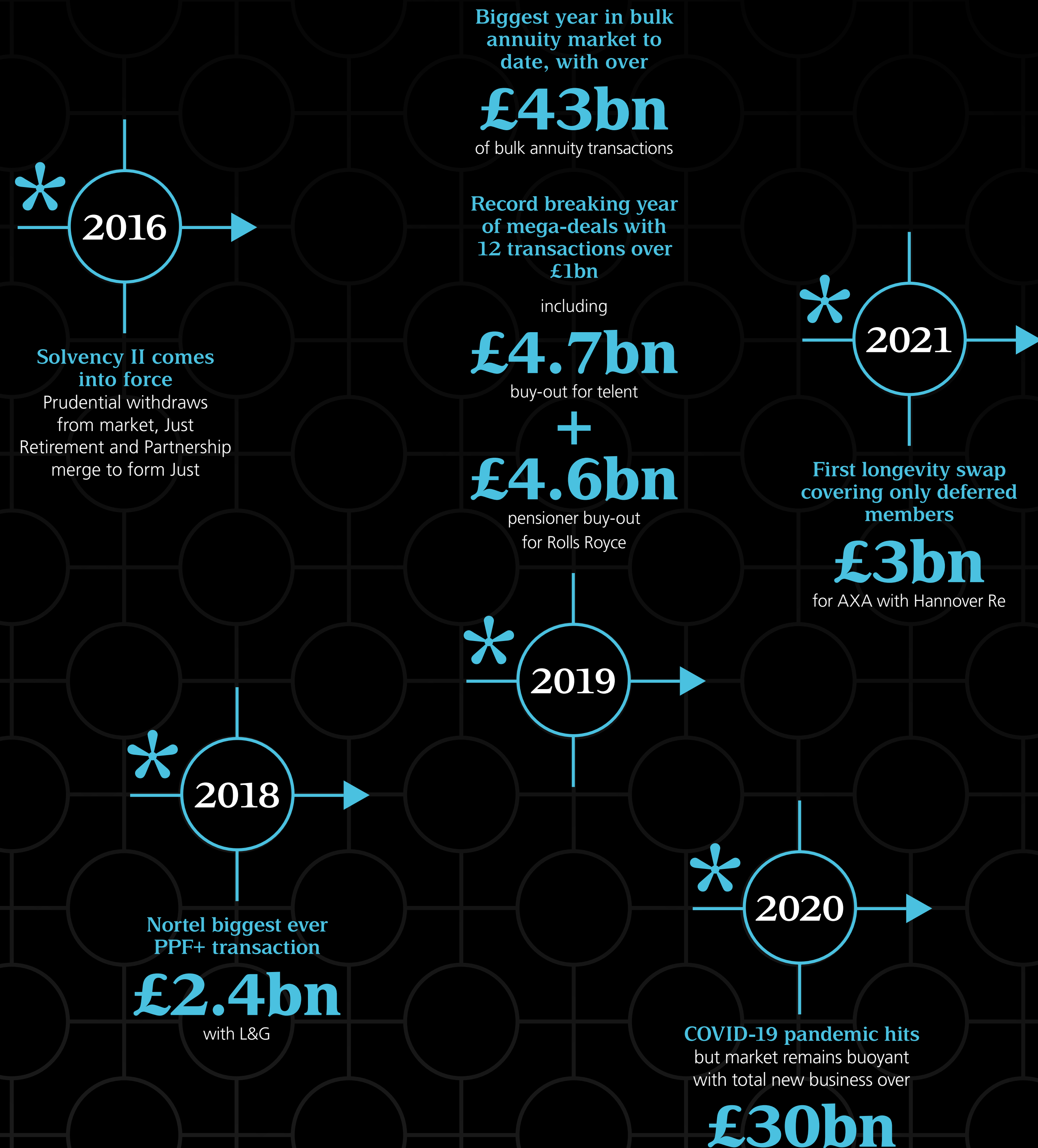
BT completes largest longevity swap to date

£16bn

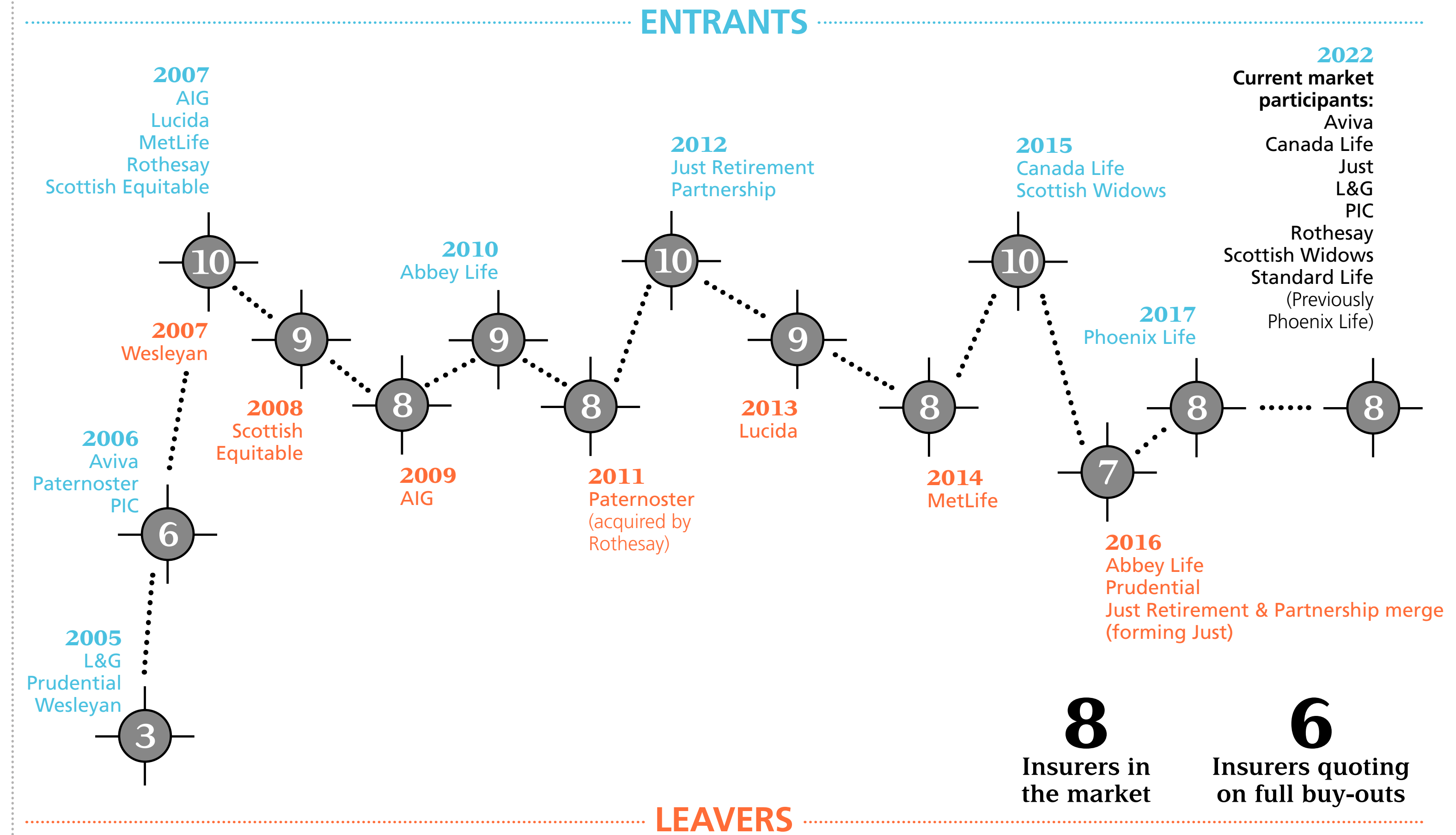
2015

Pension Freedom and Choice comes into force
leading to the contraction of the individual annuity market. Some providers move focus to bulk annuities

BULK ANNUITY MARKET TIMELINE CONTINUED



A HISTORY OF MARKET PARTICIPANTS



Friends Life, Synesis and Nomura are not included in this chart as they never wrote bulk annuity business, although they did quote

Top 20

Transactions in the bulk annuity market

Name	Size (£m)	Insurer	Date	Type
GEC 1972 Plan (telent)	4,700	Rothesay	Sep 2019	Full buy-in to buy-out
Rolls-Royce	4,600	L&G	Jun 2019	Pensioner buy-out
British Airways	4,400	L&G	Sep 2018	Pensioner buy-in
Allied Domecq (Pernod Ricard)	3,800	Rothesay	Sep 2019	Buy-in
Asda	3,800	Rothesay	Oct 2019	Full buy-in
British American Tobacco	3,400	PIC	Aug 2019	Buy-in
Undisclosed	3,300	Rothesay	Dec 2020	Pensioner buy-in
ICI	3,000	L&G	Mar 2014	Pensioner buy-in
National Grid	2,800	Rothesay	Oct 2019	Pensioner buy-in
TRW	2,500	L&G	Nov 2014	Pensioner buy-out
Nortel Networks	2,400	L&G	Oct 2018	PPF+ buy-out
Philips	2,400	PIC	Nov 2015	Full buy-out
Metal Box	2,200	PIC	Oct 2021	Full buy-out
British Steel	2,000	PIC	Oct 2020	PPF+ buy-in
Imperial Tobacco	1,800	Standard Life	Dec 2021	Pensioner buy-in
Aviva	1,700	Aviva	Oct 2019	Pensioner buy-in
Gallaher	1,700	Standard Life	Dec 2021	Full buy-in
Civil Aviation Authority	1,600	Rothesay	Jul 2015	Pensioner buy-in
Total	1,600	PIC	Jun 2014	Pensioner buy-in
National Grid	1,600	L&G	Nov 2019	Pensioner buy-in

15 YEARS OF PENSION SCHEME RISK TRANSFER

It's hard to believe that just 15 years ago, there were limited options for ongoing pension schemes to materially insure their risks.

JAMES MULLINS
Hymans Robertson

James is the Head of Risk Transfer Solutions at Hymans Robertson. Their risk transfer team led the advice on over £5.5bn of buy-ins and buy-outs during 2021, which is expected to be around 20% of the whole market. This included transactions ranging from £50m to £1.8bn and four buy-ins for pension schemes with FTSE100 sponsoring employers.

In particular there were no buy-ins or longevity swaps. L&G and Prudential were the only two insurance companies offering bulk annuities and they were typically only used by pension schemes whose sponsoring employer had gone insolvent, where there was a need to buy-out ahead of winding-up.

15 years later, almost £350bn of pension scheme liabilities have now been insured via buy-ins, buy-outs and longevity swaps and hardly a week goes by without news of the latest pension scheme to complete a material risk transfer transaction. The UK leads the world for pension scheme risk transfer. Other countries, notably the US and Canada, look on with interest. It is telling that the impressive growth has come despite material financial pressures from the credit crisis, negative real interest rates, quantitative easing etc.

It all started in late 2006 and early 2007. Several new insurance companies were set up with the single, specific purpose of helping pension schemes to insure some, or all, of their risks via buy-ins and buy-outs. Those included Rothesay and PIC. This prompted other established insurance companies, most notably Aviva, to enter the bulk annuity market and L&G and Prudential broadened their buy-in offerings to defined benefit pension schemes. These insurers all recognised that UK defined benefit pension schemes were taking risk management much more seriously.

They also recognised that this trend was likely to continue as a result of the relatively new pensions accounting standards as well as the new funding requirements and oversight from the Pensions Regulator, which was formed in 2005.

From a brand new start, Rothesay and PIC now manage around £100bn of assets between them and each insurer would easily jump into the FTSE 100 if they chose to list on the UK stock market. Attracted by the actual, and projected, growth in pension scheme buy-ins, four other established insurance companies entered this market: Just in 2012, Canada Life and Scottish Widows in 2015, and Phoenix, now re-branded as Standard Life, in 2017. A recent Hymans Robertson survey of 100 trustees found that around 50% of pension schemes are now targeting buy-out as their long-term objective, compared to just 15% five years ago. This acceleration in demand from pension schemes means that more insurance companies are expected to enter the buy-in market over the next few years.

In September 2008, it was headline news when the Cable & Wireless Fund became the first pension scheme to complete a buy-in of more than £1bn. Since then, that record has been beaten over 30 times, and the largest buy-in currently stands at £4.7bn. 2022 could well be the first year to see a single buy-in of more than £5bn. Around 45% of FTSE 100 companies who sponsor a defined benefit pension scheme have now completed at least one material risk transfer transaction. That percentage is expected to increase to 70% over the next five years.

Despite the financial and operational pressures of COVID-19, in the last three years alone there have been over £100bn of buy-ins and buy-outs. Our analysis of expected pension scheme demand shows that we can expect an average of over £50bn a year of buy-ins and buy-outs over the next 10 years.

The next ten years of the risk transfer market will be fascinating, with the advent of alternative forms of risk transfer and with £1 trillion of risk from defined benefit pension schemes expected to have been insured by the end of 2031. That amount is equivalent to around half of the value of all gilts currently issued by the UK government or around half the value of all of the companies in the FTSE 100.

£350bn
of pension scheme liabilities have now been insured via buy-ins, buy-outs and longevity swaps

The landscape of the bulk annuity market

2022 will be another busy year in the bulk annuity market, with transaction volumes likely to be around £30bn or more for the fourth year in a row. Market volumes usually dictate the headlines, but what's interesting this year is the hub of activity bubbling under the surface and the number of schemes looking to appoint a risk settlement adviser.

But what's changed this year and are we on the cusp of a new chapter for the bulk annuity market?

The catalyst

The catalyst for this surge in buy-out activity is an improvement in funding levels. Many defined benefit schemes, particularly those who are not fully hedged on interest rates, have experienced significant funding gains in the first half of 2022.

As schemes begin to lock in these gains by de-risking their asset portfolios, for the first time, many can now see the end point of buy-out. Some schemes have already focused on endgame planning, however this won't be true of all the schemes that have suddenly found themselves in a position to approach the market in the coming year.

As consultants busy themselves getting these schemes ready to approach the market, insurers are also busy working on their suite of offerings to ensure that they can accommodate the requirements schemes will have to buy-out.

With funding levels improving and company contributions already committed, many companies can see the opportunity to de-risk for a final contribution which is lower than the committed future contributions.

The market

Insurers have been talking about this wave of pension liabilities hitting the market for some time – is the wave about to crash and are they ready?

Although demand and supply continues to be in broad equilibrium in 2022, with c£500bn of pension liabilities expected to be insured over the next decade, it's likely that demand could outstrip supply at certain points. This may be particularly evident if this surge in demand from recent funding gains in 2022, as well as a number of the so called "jumbo transactions", hit the market at the same time.

We have seen a rise in insurer appetite for deferred liabilities and this increased competition between insurers will be good news for schemes. It's also good news for the many schemes that implemented a programme of phased pensioner buy-in transactions and are now in a position of being able to afford to buy-out their remaining liabilities, which tend to be heavily weighted towards non-pensioners.

Insurer pricing has been more competitive in 2022. This is driven by a number of factors, including:

- increased competition in the market as more insurers target further growth and increased market shares;
- availability of long duration, illiquid asset and funded reinsurance opportunities; and
- improved longevity reinsurance pricing.

Across the industry there is a growing consensus around the reducing cost of longevity risk which appears to be coming through in bulk annuity pricing. This is likely to have been driven by:

- competition from reinsurers;
- emerging experience data following the onset of the pandemic in 2020;
- the potential impact of the cost of living crisis and recessionary pressures; and
- the consequences of NHS backlogs, which despite additional funding, are likely to continue, at least in the near term.

This is all positive news for pension schemes and makes for a buoyant market for the coming years.

Regulatory changes?

The discussions and consultations continue around changes to Solvency II. Whilst initially thought to be a "windfall" for insurers and potentially improved pricing for new insurance transactions, the mood music seems to have changed, with proposed changes to the risk margin likely to be countered by changes to the fundamental spreads under the matching adjustment. The consultation continues, but at the time of writing, it appears that any changes are likely to have a small impact.

On a personal level, as I join XPS to grow its risk settlement team I am excited by the coming years and the number of schemes we will be able to help reach their end goal of buy-out.

STEPHEN PURVES
XPS Pensions Group

Stephen is Head of Risk Settlement at XPS Pensions Group. He has more than 20 years' experience advising both trustee and corporate clients on buy-ins, buy-outs and pension scheme wind-ups. Stephen has led on several high-profile and complex transactions for a number of FTSE 100 clients and also brings insurer-side experience from his time at Aviva where he was Head of Origination and Deal Structuring between 2017 and 2019.

MYTHS OF THE MARKET

The market is evolving at a rapid pace, and some things that may have been said in the past no longer apply to the market today. Over the next few articles, we look at some of these areas and what is true of today's market.

MYTHS OF THE MARKET

ALL RISK VS RESIDUAL RISK AND SOME RELATED THOUGHTS

SARA CHAMBERS
Gowling WLG

Sara is a legal director in Gowling WLG's pensions team and plays a leading role in its risk transfer group. Sara advises insurers and trustees in relation to risk transfer transactions, leading on a number of buy-ins and working with the wider Gowling risk transfer team on some of the largest and complex residual risk transactions. Sara maintains a general trustee advisory practice with a particular focus on helping trustees and sponsors to navigate and implement endgame solutions.

All-risk or residual risk policies – is there any difference?

The concept of an "all risks" bulk purchase annuity policy can seem like the Holy Grail. The name hints at the prospect of securing all known benefits and protecting trustees and sponsors against additional unexpected liabilities. Such liabilities can arise in a number of ways, including claims from overlooked beneficiaries, data errors and long forgotten promises to individuals recorded in "special letters".

So, could an "all risks" policy enable trustees and sponsors to sleep at night, safe in the knowledge that any such problems would sit firmly with the insurer? Unfortunately, it isn't that simple. And it never was. Did "all risks" policies ever actually underwrite all risks? In my experience, they didn't.

Insurers have always included some exclusions to the cover which they would have offered under an "all risks" policy. "All risks" became a term of art for what would more accurately (but less succinctly) have been described as "some but not all risks" or "all types of risk but with some exclusions".

The "all risks" badge likely gave comfort to trustees and sponsors that they were buying protection against most things they could envisage might go wrong. The standard exclusions in early policies, such as liabilities arising from trustee fraud, wouldn't necessarily have diluted that sense of comfort.

Whilst the "all risks" badge might have slightly oversold the prize, it was possible for trustees to obtain cover for many areas of real risk. In some instances this was possible without an insurer having undertaken detailed due diligence as part of its underwriting decision.

Perhaps unsurprisingly, the market has evolved. Deals have got bigger and, in some cases, more complex. Today, insurers want to understand the risks that arise specifically in relation to each scheme that they are considering insuring. They achieve this by getting "under the bonnet" to understand a scheme's data, administrative practices and legal documentation. Insurers are prepared to invest time and resource undertaking more rigorous due diligence than we would typically have seen, say, 10 years ago.

As well as ensuring that they can make fully informed underwriting decisions, insurers have started to provide greater clarity in their policy documents. Bulk purchase annuity policies now tend to describe more clearly than in the past the protection that trustees are buying and, critically, what liabilities will be excluded.

Essentially, insurers are focused today on taking on "residual" risks, with the expectation that trustees and sponsors will take separate steps to address known risks in relation to a scheme. Given developments in the market, insurers have tried to move the language of pensions risk transfer away from "all risks". Good scheme advisers now tend to speak to their clients about "residual risk" cover instead.

So, if today's residual risk offerings don't cover all risks, are they still worthwhile? For many schemes, the answer will be yes. Trustees and sponsors can still obtain cover for categories of risk such as legal risk, data risk and missing beneficiaries cover. The cover is typically available without a cap on the claim amount or a time limitation on the cover.

But trustees and sponsors must understand that the days of an insurer offering an open chequebook and an acceptance of all risks are long gone, if indeed they ever really existed. The cover will be limited by standard exclusions and, potentially, scheme-specific exclusions informed by the insurer's due diligence.

Stakeholders and their advisers should consider carefully whether a residual risks policy is the right investment for their scheme. They certainly shouldn't proceed to market asking for residual risk cover as a matter of course, in the expectation that the request can simply be dropped if an insurer's due diligence doesn't go as the trustees hoped.

Now more than ever, it is important for trustees and sponsors to actively consider how best to prepare for a transaction. Careful preparation can:

- help to ensure a trade is attractive to insurers in a crowded market and runs smoothly without nasty surprises; and
- potentially minimise exclusions from residual risk cover.

Preparing for the trade

Preparation for any trade is important, but it is key for a residual risks trade. Stakeholders and their advisers should start by considering the merits of residual risk cover based on a clear understanding of what cover is actually available. It would be unfortunate if stakeholders made a decision based on the mistaken belief that insurers are offering a panacea in the form of "all risks" insurance.

If trustees conclude that residual risks insurance is right for their scheme, they should plan their journey to market carefully. Trustees should take care to ensure that they know their scheme well before starting a trade with an insurer. They should also address any known issues or concerns before going to market. This will ensure that an insurer's due diligence process doesn't shine a light on latent issues in a scheme's history, which were unknown to the trustees.

Addressing known issues

By preparing properly, trustees can take the initiative. They can ensure that they understand any problems and make considered decisions in relation to their options, without being distracted by the pressure of a live transaction.

Trustee options could include rectifying benefits or obtaining legal advice to provide assurance that the benefits that have been provided are correct. If it is not absolutely clear whether this is the case, trustees could seek an employer indemnity and agree with the insurer to carve out the relevant issue from the residual risks protection.

There is often another option if the trustees and the insurer are agreed as to the steps required to correct the problem(s) and (if relevant) the associated additional premium, but there isn't time to implement the steps before inception of the trade. The parties can agree that there will be relevant exclusion(s) from residual risk cover at the outset and that the trustees must undertake specific data correction action(s) within a specified period following inception. The relevant exclusion(s) then fall away once the trustees have corrected benefits to the insurer's satisfaction.

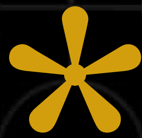
If there are multiple complex correction actions, the insurer might instead incept the "vanilla" insurance cover and postpone inception of residual risk cover until the trustees have completed the correction actions.

Generally, insurers are more likely to agree to this type of solution if trustees identified the problems and disclosed them to the insurer early in a process.

If trustees fail to prepare before going to market, it is likely that an insurer's due diligence will identify any latent issues in a scheme. This can place trustees in a challenging position because they cannot simply ignore an insurer's findings. They will need to decide quickly, and in full view of the insurer, how to address those issues, rather than having the luxury of making considered decisions behind closed doors.

> "By preparing properly, trustees can take the initiative. They can ensure that they understand any problems and make considered decisions in relation to their options, without being distracted by the pressure of a live transaction."

MYTHS OF THE MARKET



ALL RISK VS RESIDUAL RISK AND SOME RELATED THOUGHTS

CONTINUED

Is it necessary to include every risk?

Insurer due diligence can throw up some interesting discoveries. It is, therefore, wise for trustees to agree broad parameters/exclusions with the insurer before the due diligence starts. One head of cover which falls into the "be careful what you wish for" category is "execution risk". This is where an insurer is asked to underwrite any benefit changes which arise if it is later established that one or more scheme documents was not properly executed.

It is understandable that trustees would want to obtain this cover given recent case law, which invalidated multiple benefit changes due to errors in the execution of documents. But trustees should understand the insurer due diligence process before making a decision to request this cover. See Tom Seecharan's article on pages 44-47 for more details on this.

Asking an insurer to take on "execution risk" means that the insurer will inevitably review (in careful detail) the validity of execution of all of a scheme's documents. If there are errors, the insurer's due diligence will likely identify them.

Most final salary schemes have a long history. If an insurer uncovers a latent execution error from many years ago, trustees will have no option other than to establish the consequences of the error and (where necessary) make adjustments to scheme benefits.

When faced with the reality of exposing their scheme documents to such scrutiny, trustees often conclude it is reasonable not to seek this cover and to work on the basis that all of the scheme's legal documents have been properly executed.

This seems reasonable as long as the trustees are not actually aware of any problems with the execution of documents. There is no special legal requirement to review the execution of a scheme's documentation simply because it is winding up. Of course, trustees might look elsewhere for protection in relation to any latent execution risk, such as an indemnity from the sponsor.

What should trustees expect on exclusions?

Insurers will not take on all risks (they never did!). They will exclude any risks which would be neither commercially reasonable nor consistent with the interests of their existing policyholders.

Over time, insurers have put more thought into their standard carve-outs. These are, generally, non-negotiable. Whilst risk appetite differs between insurers, we would commonly expect insurers to exclude liabilities such as:

- payments other than scheme benefits, such as taxes and trustee expenses, fines and costs;
- liabilities arising due to trustee fraud;
- post-inception changes to scheme benefits;
- provision of money purchase benefits (other than AVCs where expressly taken on); and
- liabilities arising from GMP equalisation unless the process is undertaken, and the resulting benefits are administered, in accordance with pre-agreed conditions.

As mentioned above, insurers also undertake robust due diligence to assess scheme-specific risks before a trade takes place. The outcome of due diligence will determine what bespoke exclusions (if any) are appropriate for a particular transaction.

KEY TAKEAWAY POINTS

Trustee goals:

Stakeholders (and their advisers) need to decide what they want and need from their cover. Do they want residual risk cover or are there alternative forms of protection, such as an employer indemnity, which might be more appropriate?

Understanding cover:

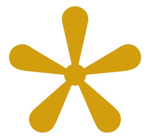
Insurers will all have standard carve-outs from residual risk cover – these will be similar (but not the same) for each insurer. In most instances, they will be non-negotiable, as they reflect the risk appetite that each insurer has in relation to specific issues.

Realistic expectations:

Insurers want to understand the risks they are taking on. When it comes to residual risks, this involves detailed due diligence. Trustees should get on the front foot by taking proportionate steps to understand the history of their scheme and address any obvious problems before inviting an insurer's due diligence team to mark their homework.

Be open with the insurer from the outset:

Insurers – some to a greater extent than others – will be willing to consider innovative ways to address problems that could potentially be a barrier to providing residual risk cover. Insurers are more likely to be flexible in terms of possible solutions if they understand the issues early on in a process.



TOO BIG FOR BUY-INS? THE MYTHS AND REALITIES

CLIVE WELLSTEED
Lane Clark & Peacock

Head of LCP's award-winning buy-in, buy-out and longevity swap team, Clive helps clients to plan, negotiate and implement de-risking strategies for their schemes. He has advised on transactions of all sizes, including some of the largest and most innovative in the market. These include nearly £9bn of buy-ins for the ICI Pension Fund, a £3.4bn buy-in for the BAT Pension Scheme and advising on transactions for the pension schemes of Pearson, Tate & Lyle, GlaxoSmithKline, Philips and Northern Bank.

For the UK's largest schemes, think those with liabilities greater than £10bn, many have worked on the basis that a single insurance transaction is off the cards – "our scheme is just too big for insurers to stomach" – or at the very least would need a series of phased buy-ins to insure all of the liabilities. More fundamentally, others have had views that the liabilities should be run-off within the existing trust structure and that "insurance is expensive and unnecessary given our scale". But how much do these statements ring true today and what might this mean for schemes with liabilities over £10bn?

There is just no need for insurance

The thinking supporting run-off without insurance is based on the premise that large schemes have the capability and scale to avoid the need for insurance because:

- Unlike smaller schemes, they have the ability to directly access the best assets in the market (assets often used by insurers to back their annuity pricing too).
- They have in-house teams who bring specialist expertise to support the investment, funding and payment of member benefits.
- The sponsor often has significant scale and provides strong covenant support to the scheme (sometimes the strength of this support is valued more than the covenant of an insurer).
- Longevity swaps can provide protection against rising life expectancies as part of an overall risk-managed approach.

Taken together, this would seem to create a stable status quo. But as time progresses, this status quo has been increasingly challenged. The focus on "target end states" has increased across the industry and has brought with it a desire to put some flesh on the bones of the "long-term run-off" concept. In doing so, a deeper examination of the insurance regime and buy-ins has led some large schemes to conclude that some buy-ins, or indeed a significant level of buy-ins, is appropriate. This has been particularly true more recently against the backdrop of schemes needing less return as funding levels have improved and focus has turned to locking in this improved position.

Indeed, for many schemes, outcomes are not symmetrical. Members have a lot to lose if it goes wrong, particularly if there is a reduction in sponsor covenant strength; but there is less to gain on the upside, even if there is the possibility of a surplus share or discretionary increase at some point in the future. Although circumstances of course vary depending on the scheme, many lawyers will point trustees towards the primacy of paying guaranteed benefits rather than seeking to maximise future surplus. Coupled with the uncertainty of sponsor covenant strength over longer time periods, starting to use buy-ins not only improves benefit security for members but also gives the largest schemes a ready-made platform to extend the insurance in future, or even move to buy-out, if circumstances support that.

Large scheme insurance just isn't possible

Since ICI broke new ground in 2014 with the first multi-billion buy-in (at £3bn), much larger transactions suddenly seemed possible. But over the last eight years the number and size of these transactions has only grown slowly. Indeed, moving above £5bn for a single buy-in has proved to be a hard nut to crack – and for the largest schemes, even a transaction at this size only scratches the surface of the total risk to be insured.

But the winds of change are coming and our work with insurers has shown an increasing ability to manage the capital, reinsurance and asset-related aspects of larger transactions, such that we are confident the transaction size record will be broken soon. Let's look at each of these areas in turn.

Capital: The recent past has shown that providers of capital to insurers are willing to provide capital to back new business where this is needed. For the very largest transactions, this may occur at or ahead of the completion of a transaction and be viewed by the insurer through a "M&A" mindset. In practice, new capital may not always be needed, as a significant amount of capital is released from insurer back-books each year. Looked at together, the takeaway is that insurers have access to significant capital on both a business-as-usual and an exceptional basis to support writing the very largest transactions.

Reinsurance: The reinsurance market has taken great steps forward in its breadth, pricing and structuring over the last three years, particularly for deferred members. The greater availability and use of funded reinsurance (broadly when the reinsurance covers longevity and asset risks), alongside a wider range of reinsurance counterparties, removes a key barrier for the very largest transactions. In addition, Solvency II reform will give insurers more options in terms of where they use reinsurance and the timing and capital impact of doing so, which increases flexibility and reduces execution risk for the largest transactions.

Assets: Sourcing attractive assets at the scale required to put forward attractive pricing is arguably the biggest challenge for large buy-ins. Central to this is how insurers plan to transition assets received from pension schemes into their preferred portfolios, and how they price the risk that they don't ultimately lock into the yields assumed in their pricing. Insurers take different approaches to this and the impact on pricing will be a key determinant of whether to carry out phased strategies or a single transaction. Pre-transitioning of assets may also be possible ahead of transacting to increase the scale of a single buy-in. For example, holding gilts in the lead up to a £1bn transaction will be sufficient for all insurers without any impact on price, but many insurers would need to receive some credit assets to price competitively for a £10bn buy-in. Finally, Solvency II reform is expected to help insurers accommodate larger transactions in future, providing flexibility for them to receive a wider range of assets from pension schemes (potentially including more illiquids), as well as widening the asset universe available to them to back competitive pricing at scale.

Conclusion

The development of the market for the very largest schemes and transactions has accelerated over the past few years, with eight of the ten largest buy-ins occurring within the past three years, and at least six

£10bn+

schemes having transacted a buy-in of some form. This provides clear evidence that large scheme thinking – and actions – are changing.

I am convinced this direction of travel will continue and accelerate, bringing ever larger schemes to consider and transact buy-ins. Not only this, the planets are aligning for the largest individual transaction record to be broken soon, as the buy-in market moves to its next phase of growth.

YOU CAN'T DEFER THE INEVITABLE – INSURING DEFERRED LIABILITIES

ROSIE FANTOM
Barnett Waddingham

Rosie is a Partner within Barnett Waddingham's Risk Transfer team. She has over 10 years of focused pension risk transfer experience. Over the last decade, Rosie has led advice to both trustees and sponsors, including Allied Domecq Pension Fund's £3.8bn buy-in, and the innovative and complex £2bn buy-in for the Old British Steel Pension Scheme. Rosie has also supervised insurers during her time at the PRA and led transactions from the insurer side at Scottish Widows. She draws on this breadth of experience and understanding of the different stakeholder perspectives to help her clients get the best from the risk transfer market.

Where did the market for deferred liabilities start?

Before 2007, most bulk annuity transactions were written for full scheme buy-outs. The market was comparatively small, with only two insurers actively participating. Demand for bulk annuities was limited, being driven by the occasional scheme that could afford to insure all of its liabilities, or schemes that transacted as a result of some form of sponsor-related activity. Against this backdrop of small market size and low demand from pension schemes, there was little incentive for insurers to enter the market, optimise their pricing and enhance their wider offerings.

The first pensioner buy-in transactions completed in 2007. This was a key step in the bulk annuity market's evolution as it opened up opportunities for pension schemes who couldn't afford to insure all of their liabilities, but saw value in securing a subset of liabilities. As additional transaction structures were developing, new insurers also entered the market generating more competition. The bulk annuity market as we know it was born.

In the early days, transactions involving meaningful deferred liabilities were relatively rare, with the majority of market volumes being in respect of pensioners. This was due to demand from schemes being skewed towards pensioner buy-ins, and few schemes being able to afford full buy-out. Further, insuring deferred liabilities was significantly more expensive than the equivalent pricing for pensioner liabilities. This was compounded by schemes typically reserving for pensioner liabilities on a lower risk basis than deferreds, meaning that pricing for pensioners tended to look more attractive relative to pension scheme funding metrics. Traditionally schemes have had a higher risk appetite when investing to meet deferred liabilities, recognising the longer time horizons for benefits falling due.

How did the early years shape today's market?

As the bulk annuity market was developing, insurers developed their ability to price transactions more attractively, including those deals with longer duration liabilities. Transactions involving deferred liabilities have gradually become more common, largely due to schemes' finances improving through contributions and investment returns. Pricing refinements have involved insurers gaining access to long dated assets with an expectation of higher risk-adjusted returns. Insurers' asset sourcing and structuring capabilities have expanded significantly since the early days of the bulk annuity market, with insurers looking at wider corporate bond markets and alternative illiquid asset pools such as social housing and commercial real estate.

Changing the returns side of the equation helped insurers price the liabilities using a higher discount rate and so deliver better pricing. This is particularly true for longer dated liabilities where reinvestment risks can dampen return expectations and increase capital requirements. In today's market, successful asset origination is a fundamental part of a bulk annuity insurer's toolkit in pricing deferred liabilities competitively.

Aside from their longer duration, deferred liabilities are more uncertain due to the optionality members can exercise. As the market developed, insurers grew more confident in setting terms for these options and started to incorporate flexibility around terms as deal features. For example, we saw insurers being able to deliver premium savings by deviating from their standard member option terms. Again, considerations around member option terms or exercises continue to be features of today's market.

In the years that followed, there were some notable developments in insurer offerings that remain characteristics of the deals we see today. For example, we have seen transactions test the art of the possible regarding pensions risk transfer. Today, trustees and sponsors are commonly considering whether to seek residual risk cover for larger transactions.

What challenges did Solvency II bring?

The bulk annuity market flourished under the Solvency I regulatory environment, whilst the spectre of significant regulatory change grew larger. Solvency II presented a myriad of challenges for bulk annuity insurers, from designing and obtaining regulatory approvals for bespoke capital models, through to gaining permission to recognise expected investment returns through the Matching Adjustment. Solvency II went live on 1 January 2016, with insurers finding their feet with the new regulations.

As 2016 progressed, insurers increasingly found ways to deliver for schemes, albeit with new issues to consider. The nature of the Matching Adjustment regulations, and its significance for insurers, saw deal features and policy terms evolve accordingly. In particular, cashflow matching requirements changed how insurers priced and optimised their offerings for individual cases. The challenges Solvency II created for insurers were less acute, or more readily navigated, for pensioner liabilities. 2016 saw lower transaction volumes, with total volumes not recovering to pre Solvency II levels until 2018.

At the time, Solvency II was cited as making deferred liabilities around 5% more expensive to insure. One of the main reasons highlighted was the "risk margin" aspect of the new regulations. Simply put, this is capital held against "unhedgeable" risks, which includes longevity risk. For bulk annuities, the capital associated with the risk margin is significant. Insurers have found ways to manage this and improve capital efficiency by using suitable reinsurance. Since 2016, insurers' access to longevity reinsurance has continued to evolve, with the vast majority utilising pre-agreed flow treaties for smaller transactions and bespoke arrangements for larger cases. Typically, reinsuring longevity risk for pensioner liabilities has been a much more readily available and cost effective option, and insurers focused on these arrangements initially in the wake of the new regulations. This has changed in the last few years. We are seeing significantly more capacity and easier access to longevity reinsurance for deferred liabilities, with around 20% of longevity reinsurance established over the last couple of years covering deferred liabilities.

What does the future hold?

Pension schemes are expected to increasingly demand access to competitive deferred pricing, particularly as many schemes have already insured their pensioner liabilities and are looking to insure their remaining liabilities. Insurers are responding to this changing market dynamic, with insurers who had previously focused on pensioner only transactions expanding their capabilities to write buy-out deals involving deferred members too. We are starting to see the impact of this now, with transactions involving deferred liabilities accounting for more than 60% of deals written in 2021.

This raises the stakes for insurers to improve their ability to price deferred liabilities. We have seen the evidence of this emerging in real time pricing, albeit recognising that direct pricing comparisons are skewed by wider market condition changes. Over the last five years, deferred pricing has improved by more than 5%. This improvement has come from different sources, including beneficial access to suitable long dated assets coupled with longevity reinsurance for deferred liabilities to improve capital efficiency, set against a backdrop of rising interest rates and lower mortality improvements. Whilst deferred pricing has improved in recent years, it can be challenging for insurers to deliver a heavily deferred liability deal. Although, it's worth noting that deals have taken place, close to £1bn, with deferred liabilities making up more than 90% of the transaction.

Whilst the rumblings around potential adjustments to the Solvency II rules applicable in the UK continue to grow louder, insurers have shown that they will innovate to deliver for schemes, and respond positively to evolving regulations. The stage is set for demand to accelerate as schemes reach full buy-out funding in the coming years, with significant volumes of deferred liabilities to be insured.

MY TOP TIPS FOR TRUSTEES AND SPONSORS APPROACHING TRANSACTIONS WITH DEFERRED LIABILITIES:

1.
Undertake considered preparations so that insurers can be given the information they need to refine their pricing approach, for example to support their access to longevity reinsurance.

2.
Understand your scheme's potential time horizon for buying out and the likely liability profile at that point. You can then use this to help inform your approach to market. Schemes looking to insure fully, or very significantly, deferred populations may be better served by a targeted approach, working with insurers over a longer time period to design and price a deal that works for your objectives.

3.
Have an eye on the long-term objective, which for many is likely to be the wind-up of the pension scheme. Viewing the transaction in this context will help you define your overall objectives more fully and can inform your approach to the preparations and the transaction itself.

Self-sufficiency

buy-out

What should trustees be thinking about and why might a scheme choose one or the other as their endgame plan?

Self-sufficiency VS buy-out

The primary duty of a trustee is to ensure that members' benefits are paid in full as and when they fall due. This requires trustees to look ahead and set clear plans for how this objective will be delivered. In other words, to identify a target end state and work towards it.

With the emergence of consolidators and other innovative solutions, there is now a much wider range of potential end states for pension schemes.

Here I focus on the two that are currently the most established – buy-out with an insurer and "self-sufficiency".

WHY IS THIS RELEVANT FOR ALL SCHEMES?

Over the last decade, this topic has become increasingly relevant. Why? Pension scheme funding levels have improved materially through favourable investment returns and sponsor contributions. This has allowed trustees to significantly de-risk their investment strategies, increase hedging levels and lock-in strong funding positions. Therefore, for a lot of schemes, the end state is now much closer than anticipated.

Even for those not in this position, there is regulatory change on the horizon that will require the target end state to be considered. The Pension Schemes Act 2021, which is expected to come into force later this year, will require trustees to agree a funding and investment strategy for the long-term with the sponsor.

Setting aside both of these reasons, it is simply good governance. Being clear on what they want to achieve, and when, allows trustees to develop a robust framework that improves decision making, and therefore, outcomes for members.

WHAT DO WE MEAN BY SELF-SUFFICIENCY?

Buy-out as an end state is well understood – purchasing a bulk annuity from an insurer, which is then converted into individual policies in the members' names. The trustees' responsibilities are discharged and the scheme is wound-up.

However, self-sufficiency or "low dependency" is less well defined. From my perspective, self-sufficiency is characterised by a low risk, cashflow-matched investment strategy, with very little likelihood of requiring additional funding from the sponsor. Longevity and demographic risks are the predominant unmanaged risks, although they may be managed in part via partial buy-ins or longevity swaps. The trustees continue to run the scheme until the last payment is made (or perhaps more realistically, moving to buy-out when it is affordable or the scheme is smaller). Figure 1 sets out a high-level comparison between near-term buy-out and long-term self-sufficiency.

HOW TO DETERMINE THE TARGET END STATE?

As a bulk annuity specialist, you might expect me to say that buy-out is always the right solution but the truth is there's no "one size fits all" solution. There are, however, some common points that trustees should consider in determining their target end state:

1. Affordability – self-sufficiency is typically cheaper than buy-out, particularly for schemes with a significant proportion of non-pensioners (due to the higher insurance cost for these members). Whilst this gap will narrow naturally over time through investment returns, retirements and transfers out, schemes may be relying on sponsor contributions to make buy-out a reality in the short to medium term.

If buy-out is a longer-term ambition, the buy-out cost can be met over an agreed period, through a combination of contributions and investment returns, albeit with a moving target given the uncertainty over future market pricing.

2. Risk appetite – a buy-out would transfer the investment, longevity and demographic risks to the insurer, and the cost must be considered in that context. However, some trustees and sponsors may be prepared to accept these risks, particularly if they believe they can run-off the scheme at a lower cost than buy-out. This could be driven by their longevity beliefs – for example, a belief that improvements in life expectancy will tail off in the coming years.

3. Covenant – for schemes choosing to be self-sufficient, even with a very low risk strategy, there remains a risk of a deficit arising in the future. Whilst this can be managed through a stronger funding target and/or partial buy-ins/longevity swaps, trustees understandably want confidence that the sponsor can cover this risk in the long term. The challenge is then whether there is sufficient visibility of covenant over that period.

4. Member outcomes – if self-sufficiency is pursued, trustees ought to consider the likelihood of benefit reductions should the sponsor default. Equally, trustees should weigh up the likelihood of an insurer default. For many, the strength of the insurance regulatory regime and the protections provided by the Financial Services Compensation Scheme will increase the likelihood of members receiving their benefits in full under a buy-out (relative to self-sufficiency).

5. Ongoing governance – in a self-sufficient state, there are material costs of running a pension scheme, for example adviser and investment management expenses, plus the management burden for the trustees and sponsor. These costs are eliminated on buy-out and wind-up, which can often help to justify any one-off funding from the sponsor.

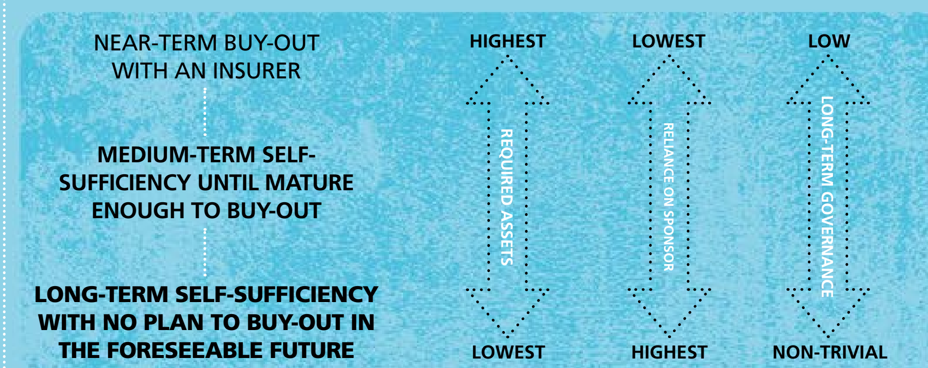
6. Size of the scheme – larger schemes have the scale to invest in a more sophisticated manner, more akin to how an insurer would invest, and can accommodate the governance that comes with self-sufficiency. Small schemes typically struggle to access such investment opportunities and the ongoing governance/costs of running a scheme are more of a burden.

7. Sponsor views – it is key to understand the sponsor's views, not least because of the incoming requirement to agree a long-term funding and investment strategy. For example, some sponsors may be concerned about the accounting impact of buy-out, in particular if there is a material loss flowing through its Profit and Loss. Others may be keen to move the pension scheme off the balance sheet.

Self-sufficiency is not necessarily a permanent end state in the same way that buy-out is, and whilst there is nothing in legislation that says trustees must buy-out, I expect many will transition to buy-out when the time is right, for example when pricing becomes sufficiently attractive.

> "Self-sufficiency is not necessarily a permanent end state in the same way that buy-out is"

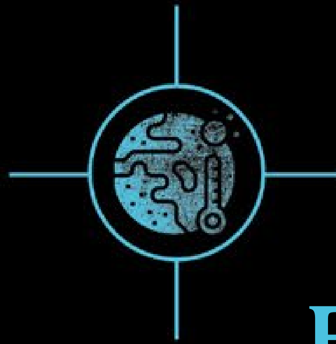
Figure 1



GREG ROBERTSON
WTW

Greg is a Director in WTW's Transactions Team, with over eight years' experience of advising trustees and sponsors on their de-risking journeys. He has advised on a large number of buy-ins and buy-outs, from as small as £1m through to the largest transaction of 2020, a £3.3bn buy-in with Rothesay for a confidential WTW client.

CO_2



Estimation & comparison of carbon emissions

The degree of global warming depends solely upon total cumulative greenhouse gas emissions. These have grown rapidly in recent decades, largely due to human activity.

The Intergovernmental Panel on Climate Change (IPCC) has set a carbon budget of **500 Gt CO_2** for the planet to have a **50%** chance to not exceed **1.5°C** of warming. The current rate is about **50 Gt CO_2** per annum. How should that very tight budget be allocated among the countries, companies and people of the world? It's helpful to bear a few example numbers in mind when trying to understand the scale of the problem.

1.

The average UK home is responsible for

4.8 t CO_2e per annum

due to heating, lighting, cooking and other uses of electricity.

2.

Rothesay, a financial services company which has taken steps to source fully renewably generated electricity and which keeps business travel to a minimum, nevertheless employs 350 people typing at computer terminals who need to be kept warm in winter using a gas boiler in the basement of the Post Building. Rothesay is responsible for about 100 t CO_2e per annum but has contracted with Climeworks to physically capture and store deep underground, in mineralised form, 2,000 t CO_2 over the next decade. **Our emissions work out to around 0.3 t CO_2 per employee which, when you realise that some of our employees work 12 hour days, compares favourably to the household emissions mentioned above.**

3.

Lafarge, a major cement manufacturer whose industrial process not only requires extreme heat but also produces CO_2 as a by-product of the chemical reaction, **is responsible for about 120 million t CO_2e per annum. This number can be usefully re-expressed as 0.55 t CO_2e per tonne of cement.**

4.

China, a country with a hearty appetite for coal burning, produces 14 billion t CO_2e per annum; more than double that of any other country. But China is responsible for much of the world's manufacturing and has a population of 1.4bn people and so while their per capita emissions of 10 t CO_2e are higher than for the UK, they are half those for the USA and Canada and a third of those for a typical Australian.

Any kind of measure of carbon emissions per unit of something else (household, employee, tonne of production, dollar of revenue) is known as a carbon intensity. While we have to bear in mind reducing total emissions is the ultimate goal, it is very helpful to think in terms of carbon intensities when trying to decide where to focus attention and make comparisons between different entities in the same line of business or, depending on the choice of intensity measure, even across very different entities.

The most broadly applicable carbon intensity is also the crudest. It measures the quantity of CO_2 emitted per unit of revenue generated. It is troubling for some observers because it carries an implication that the more financially productive you are, the more emissions you deserve to generate. Nevertheless, every entity to which we lend has some useable measure of revenue by which we can scale its carbon emissions. In the most obvious case we use corporate turnover, but for an entire sovereign nation we can extend this notion to GDP; while for an individual property we can gauge the rent that is either contracted or could theoretically be earned in the case of an owner occupied building.

What is a good benchmark for this measure of carbon intensity? We think the UK's national emissions in tonnes of CO_2 per unit of GDP (measured in millions of US dollars) is a good starting point because it includes the contributions from all individuals and businesses in the country. For 2019 its value was 160 t CO_2e / mm USD GDP. We can use this benchmark in a couple of ways: first it sets the scale for deciding whether we are dealing with a highly emitting entity; second if we can make our portfolio track the evolution of that number over time, then, providing the UK fulfils its legal obligation to get to net-zero by 2050, so will Rothesay live up to its related commitment.

Revenue based carbon intensity is a useful way of putting all sorts of different entities on a similar footing, but it has drawbacks. If our primary goal is to track emissions over time, this can be obscured by the vagaries of the market. A company may indeed have taken steps to become more energy efficient but if its business has coincidentally experienced poor revenue generation then the carbon intensity could easily have increased. Similarly, if the UK's emissions and GDP (measured in sterling) are unchanged year on year but the pound has weakened versus the dollar, then its carbon intensity will rise.

Finally, as the world contends with much higher rates of inflation, revenues will naturally rise, and even without any reductions in emissions, this will lead to lower carbon intensities and the false comfort that brings.

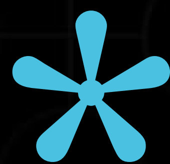
A second drawback is that revenue based carbon intensities have relatively weak predictive power. Imagine that company A with revenues of a billion dollars discloses emissions of a million tonnes of CO_2e per annum, which translates to a carbon intensity of 1,000 t CO_2e / mm USD. Now suppose that company B, a competitor to A, declines to provide any public emissions data but its accounts reveal revenues of $500m. We can then deduce that their emissions are likely to be around 500k t CO_2e per annum, assuming the carbon intensities of the two companies are similar. This estimate is reasonable but not terribly reliable because there can be so many other factors affecting revenues that are not directly linked to emissions.

This is why, when comparing companies in the same sector, for example the cement industry, it is useful to understand how much CO_2 is produced in manufacturing a tonne of cement. Assuming the industrial processes are similar at competing firms then we will be able to make a much more accurate prediction of emissions levels at the recalcitrant company based upon their production figures than is possible by reference to nothing but earnings. It is also through observing declines in production-based carbon intensity metrics that we will spot true industrial innovation as opposed to mere price increases leading to reductions in earnings based carbon intensity.

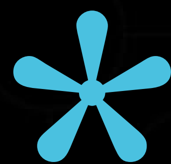
DAVID LAND
Rothesay

David is Rothesay's Head of Investment Strategy. Previously, David was a Managing Director at Goldman Sachs and worked as a trader in Interest Rate Products and Credit Derivatives since 1993. Prior to joining Goldman Sachs, David was a programmer at the IBM UK Scientific Centre.

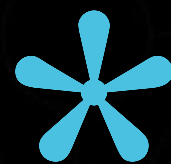
Mortality– changing the long-term assumption



What is it?

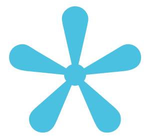


How do you set it?



When does it change?

A global prospective



The long-term rate: what is it?

MARK COOPER
Rothesay

Mark is head of longevity risk at Rothesay and works on demographic assumption setting and capital modelling. Mark has been at Rothesay for 11 years, having worked in the new business pricing and demographic assumptions teams. He is a Fellow of the Institute and Faculty of Actuaries and is a member of the CMI Annuities Committee.

Mortality improvements – recap

At a high level, mortality improvements relate to the assumption made by actuaries that mortality rates (the annual probability of dying) improve through time. For example, if we are assuming the mortality rate for an 80 year old male in 2022 is 4%, then if we think mortality improvements will be 1% over the year, our assumption for an 80 year old male dying in 2023 will be 3.96% (=4%×(100%-1%)). To enable us to value liabilities for members of different ages, we require mortality improvement assumptions for all ages and years. The most common way to do this in the UK over the last decade has been to use the Continuous Mortality Investigation (CMI) Projections Model. This uses data from historic England and Wales population mortality improvements to project short-term mortality improvements. These blend into an assumption about longer term mortality improvements which are set by users of the model.

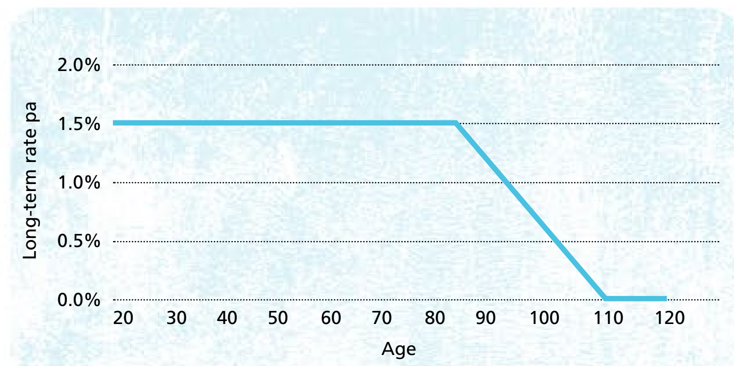
Long-term rate – what is it?

The long-term rate (LTR) is the assumption adopted for long-term mortality improvements per annum. It is often described as a single percentage for ease of communication and comparing the strength of different assumptions. For example, a common assumption used with the core CMI model in the UK is 1.5%pa. However, there are other assumptions made alongside this single percentage which have an impact on pension scheme liability valuations. We describe two of the more material assumptions briefly in this article.

Long-term improvements taper by age

Mortality rates at the oldest ages have not changed very much over the last half century, a period when mortality rates at younger pensioner ages have improved significantly. This has been explained by there being a biological limit on life where the impact of co-morbidities and 'diseases of older age', such as dementia, have led to fairly stable mortality rates through time. To allow for this effect, the core CMI model 'tapers' mortality improvements from the desired long-term rate at age 85 (Taper Start Age) to 0%pa at age 110 (Taper End Age). This is illustrated in Figure 1 for a long-term rate of 1.5%pa.

Figure 1 – CMI Projections Model – Core Age Taper for LTR of 1.5%pa

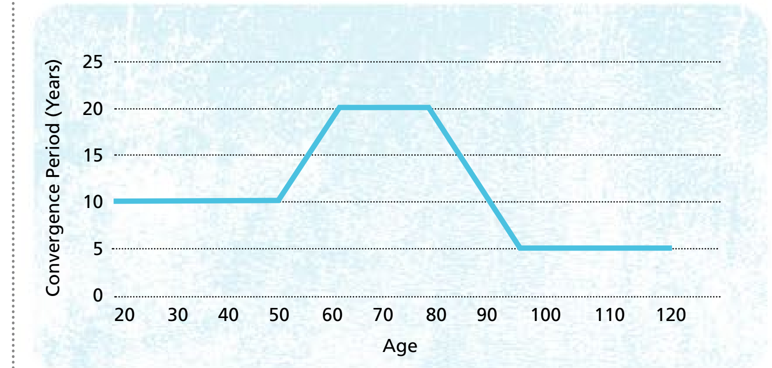


Period of convergence to the long-term rate

We need to make an assumption about how quickly we converge to the long-term rate (the 'age-period convergence period'). This reflects the period of time where we blend from short-term mortality improvements (calibrated using recent data in the CMI model) to the long-term rate. In the core CMI model, the convergence period varies by age; this is set out in Figure 2. The reasons these periods vary are broadly as follows:

- A shorter period of 10 years is used for younger ages because, historically, mortality improvements for younger adults have varied a fair bit through time (so we project recent improvements for less time).
- Most pensioner ages have a period of 20 years, reflecting that a few causes of death dominate these ages. As such, trends observed in data may persist for longer.
- A very short period (5 years) is used for ages 95 and above reflecting the view that improvements at older ages converge to zero as set for the LTR (i.e. less confidence on short-term improvements projected from recent data for older ages)
- In practice, pension scheme liabilities are more sensitive to the assumption for the pensioner and older ages

Figure 2 – CMI Projections Model – Core Age-Period Convergence Period



Financial sensitivities

To illustrate the materiality of the long-term rate assumption, we consider the financial sensitivity of stressing the long-term rate for three types of pension scheme liability: 100% deferred lives, 50% deferred lives / 50% pensioner lives and 100% pensioner lives. In the first instance, we look at the percentage change in present value from changing the long-term rate in the core CMI 2020 model. This is set out in Table 1 below.

These results show that the stress up and down is fairly symmetrical. They also show that deferred liabilities are more sensitive to changes in the long-term rate than pensioner liabilities. This is intuitive, given that the longer duration liabilities will have cashflows that extend into the period where the long-term rate is most prevalent. Furthermore, the pensioner sensitivity is smaller due to more exposure to the ages where the shock is tapered; although, this is partially offset by the shorter convergence period at older ages.

Table 2 looks at how the liabilities change when the tapering and convergence periods discussed above are stressed. For tapering, we consider a sensitivity of moving back to the assumption adopted for CMI models 2009 to 2015, where improvements were assumed to taper from age 90 to zero at age 120 (rather than from age 85 to age 110). This is a more conservative assumption than assumed in the current model and was updated as part of the review of the model in 2016.

These results show that a modest modelling change to the tapering assumption can lead to a change in present value equivalent to around half of the 0.5% stress in LTR that we considered in Table 1 for deferreds, and around two thirds for the pensioner liabilities. As per the sensitivities of moving the core LTR, the deferred liabilities are more sensitive than the pensioner liabilities, but here the pensioner liability stress is proportionately higher due to the shorter convergence periods for the older ages (where we are increasing the mortality improvements by extending the taper).

Table 2 also shows the increase in present value from reducing the convergence period. This is driven by the fact that recent mortality improvements (excluding the effects of the pandemic) have been historically low (around 0.6%-0.7%pa). Therefore, bringing the long-term rate assumption of 1.5%pa closer leads to an increase in mortality improvement assumptions. This is fairly uniform across pensioner and deferred liabilities. We note that this sensitivity is very dependent on the relationship between current mortality improvements and the assumed long-term rate, hence can change materially if the relative difference of these two assumptions moves.

Discussion

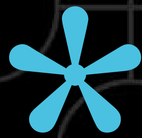
These sensitivities show the importance of the long-term rate assumption in valuing pension scheme liabilities and that, although the headline number is an important decision, the age tapering and convergence periods adopted are also important parts of the assumption setting process.

Table 1 – Financial Sensitivities of changing the LTR

% Present Value Change from Core CMI20 1.5%pa LTR	100% Deferred Liability	50% Deferred 50% Pensioner Liability	100% Pensioner Liability
Move LTR from 1.5% to 1.0%pa	-2.5%	-2.0%	-1.4%
Move LTR from 1.5% to 2.0%pa	2.5%	2.0%	1.4%

Table 2 – Financial Sensitivities of changing the LTR tapering and convergence assumptions

% Present Value Change from Core CMI20 1.5%pa LTR	100% Deferred Liability	50% Deferred 50% Pensioner Liability	100% Pensioner Liability
Move Taper Start Age to 90 and Taper End Age to 120	1.3%	1.2%	1.0%
Reduce Convergence Period by 50%	0.7%	0.7%	0.8%



The long-term rate: how do you set it?

Actuarial assumptions are often derived using a blend of science and judgement. Deciding the level of the long-term mortality improvement rate is a very good example and one where judgement plays as significant a role as the results from models and available statistics.

STEPHEN COURQUIN
RGA

Stephen is Head of UK Actuarial Research at RGA. His current role includes researching and developing pricing bases for protection and longevity products. Stephen has spent almost 3 decades in the industry in a variety of roles including research, pricing financial reporting and risk management. He has worked primarily for Life Reinsurance companies and also has experience working for direct insurers and in consultancy. Stephen is an active member of insurance committees and is currently a member of the CMI Assurances Committee and ABI Genetics Working Group.

With any projection into the future, it is important to keep in mind a basic principle – whatever result is produced, it will be wrong. The aim is not to be too wrong! Another principle is to not be too wedded to a particular methodology and preferably approach the problem from different angles, using various methodologies and models.

This section sets out some common approaches used to examine potential assumptions for the long-term rate. Each will provide a different answer and it is the job of the basis developer to use their judgement to pick a final answer from the range calculated.

Historic models

A relatively straightforward exercise to undertake is to examine mortality trends that have occurred in the past. The advantage of historic data models is that they can be straightforward and, hence, a relatively short time-bound exercise depending on the level of detail that the developer is prepared to go into. They illustrate the range of trends and patterns that have been experienced over different time periods and can also highlight the cyclical nature of mortality improvements in some countries.

One of the key elements of historic models is identifying key drivers of mortality improvements in the past, and asking the question: will such influences be repeated in the future? Perhaps in a slightly different form? An example would be the impact of the uptake and cessation of smoking – a key driver of improvements in the UK from the late 1980s to the 2000s. This specific cause of improvement is unlikely to be repeated (at least in terms of magnitude), but there may be similar situations in future years such as the rise, and hopefully one day fall, in obesity levels.

The significant drawback of historic models is obvious – they look backwards and the long-term rate is a forward-looking assumption. How relevant is the past to predicting the future, especially a future starting in typically 20 plus years' time? Does it make sense to look 30 to 50 years into the past when we're interested in a rate that is aimed at the period 20 to 40 years into the future?

“The significant drawback of historic models is obvious – they look backwards and the long-term rate is a forward-looking assumption.”

Expert opinion

Looking backwards enables the basis developer to obtain nice (seemingly) “solid” numbers – something actuaries generally like. The opposite of this is collecting the views of experts.

There will be a wide range of views from experts in various fields with estimates at different ends of the spectrum. Expert opinion will be available from a large number of sources including medical, futurologists, actuarial societies and consultancies to name a few. The amount of information available on this subject is practically unlimited and hence it is necessary to filter and distil into accessible amounts to include in the trend assumption considerations.

Expert opinion of future events, by its very nature, will be subjective. The range of subjectivity will of course depend on how far into the future the opinions are being sought – the range of estimates of trends for specific causes of death in 1 to 5 years' time will be much narrower than views on trends in 20 years.

An argument against forecasting trends using expert opinion is that it often tends to be pessimistic. This is because historically, future progress in extending life expectancy has been different from past progress. Additionally, experts understand the past but have difficulty foreseeing future advances[1].

Projection models

Models are useful for providing different scenarios with respect to the different drivers of mortality improvements. Examples of models available are:

- **Cause of death models:** This entails projecting mortality improvements forward at the individual (or grouped) cause level. This can be effective in the short and medium term to obtain a view of the constituents of the all-cause improvement rate. Longer term projections however will increasingly rely on subjective assumptions and, equally subjective, expert opinion including how the different causes of death interact with each other and how this might change in the future. Such models however can provide scenario-based analysis which is useful for obtaining potential maxima and minima bounds for the long-term rate.
- **Disease based models (or “Cause of cause of death” models):** these models take the underlying drivers of change in mortality to the next level below the cause of death models, for example changes in smoking habits impacting on cardiovascular risk. They add a further layer of explanatory insight, but also a further layer of complexity and subjectivity.
- **An alternative approach** is provided by models that group the different drivers of mortality e.g. lifestyle, health, environment, medical interventions, as well as advances in such areas as regenerative medicine and retardation of aging. These models provide an alternative viewpoint although, as with all models, subjective decisions of how these drivers develop into the future and interact are required and hence return to the knotty problem of interpretation of historic data and expert opinion.

International comparisons

Comparing mortality levels and trends across countries could be helpful in determining the range of possible outcomes, especially given the increased importance of globalisation with regards to drug development and research. However, there is also a need to be mindful of legitimate differences between populations because of lifestyle, societal and genetic differences that have existed in the past and could persist into future years.

Guidance from actuarial organisations, government departments and other mortality projection research

Many actuarial and governmental organisations around the world will have investigated the long-term rate assumption. Examining what others have done before in specific markets can be a starting place for new research, or at least for obtaining a feel for what currently exists in the different markets.

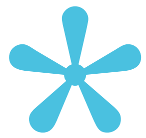
1 The Advancing Frontier of Survival: With a Focus on the Future of US Mortality by James W. Vaupel

Of course with such a subjective assumption as the long-term rate it can be difficult (or brave) for any organisation to suggest a radical departure to the broad market consensus. “Group think” on such an important assumption naturally should be avoided and hence it is the basis developer's role to provide their best estimate view whilst being cognisant of the range of plausible results and the impact of changing the existing assumption.

Concluding remarks

Arriving at a suitable assumption for the long-term rate really is one of those situations where if you ask four actuaries for an opinion, you will receive five different answers (if not more). The above provides a sample of the methods used by actuaries to examine this issue. The real value is in the judgement that comes from examining this information and deciding on the result.

“Arriving at a suitable assumption for the long-term rate really is one of those situations where if you ask four actuaries for an opinion, you will receive five different answers (if not more).”



The long-term rate: what drives a change in the assumption?

MATT FLETCHER
Aon

Matt is an Associate Partner in Aon's Demographic Horizons team. He is Aon's expert on drivers of mortality change including international mortality trends, causes of death and COVID-19. Matt is the current chair of the CMI SAPS Committee, which produces the standard pension scheme mortality tables for the UK actuarial profession. He is also a member of the profession's COVID-19 Actuaries Response Group, which produced 100 bulletins and analyses over the course of the pandemic.

The long-term rate is, by definition, something that won't be reached for many years (and even when we find ourselves where the "long-term" is today, we will set a rate that applies many years after that). This means that fluctuations in short-term mortality, even shocks as extreme as the pandemic in 2020 and 2021, should not automatically lead us to change our view on what might happen over the longer term. This also tends to make the long-term rate "sticky" – there aren't many things that could happen that would give any certainty that a particular long-term rate is less appropriate today than when it was set three (or more) years ago.

For example, long-term rates typically assumed by pension schemes and (re)insurers have been in the range of 1% to 2%pa since the CMI Mortality Improvements Model was first published in 2009. Similarly, (though their definition of long-term rate is slightly different) the ONS have used a rate of 1.2%pa in population projections for many years. Bearing in mind that mortality improvement rates were materially higher than 2%pa when these long-term rates were first put in place, this long-term approach has been vindicated.

On the other hand, we do expect the long-term rate to change in light of emerging data, albeit only gradually. So it is natural to ask what changes – gradual or sudden – could lead to a change in long-term expectations for mortality improvement?

There are (as ever) topical issues of concern that we would tend to ascribe to the shorter term, i.e. not include when considering changes to the long-term rate.

Currently these might include:

- **The COVID-19 pandemic including "long COVID" and other knock-on impacts, positive as well as negative. We see this as best represented by a one-off shift in mortality.**
- **The emerging cost of living crisis, exacerbated by recent events in Ukraine. Again this seems best treated as a shorter term fluctuation and not part of the long-term rate.**

Drivers that could have a radical impact on the long-term rate include the following:

- **Biotechnology:** mRNA vaccines captured the headlines because of their effectiveness in reducing the worst effects of COVID-19 - with further development, mRNA technology has the potential to deliver individually-tailored vaccines against some cancers. Technology such as CRISPR-Cas also has the potential to treat a wide range of diseases, especially those with a genetic cause – this could lead to extreme improvements in life expectancy. On the negative side, biological agents may become more easily available to bad actors with malintent and these could be massively detrimental to longevity – imagine COVID-19, but with much higher mortality.
- **Information technology/artificial intelligence:** We already have watches that can take ECGs and monitor the wearer's heart rate for irregularities suggestive of atrial fibrillation. In the long term, AI and robotics hold out the potential for major scalable shifts in longevity.
- **Primary energy supply/climate change:** The world faces a challenge in relation to its primary energy supply – energy consumption is growing but current primary energy sources are non-renewable and generate pollution. It seems reasonable to expect that continued high levels of use of current energy sources will ultimately have a negative impact on longevity.
- **Anti-ageing technology:** This is a little more "moonshot", but there is considerable capital invested in researching ways in which the biological processes that drive ageing can be delayed. Though success would take time to validate, a breakthrough in this area could change our view of long-term mortality.
- **NHS funding:** Though not as glamorous as the other drivers discussed, in the UK, healthcare delivery via the NHS is dependent on government funding decisions. Hence long-term pledges on healthcare spending may lead to adjustments in views of long-term mortality, both positively and negatively.

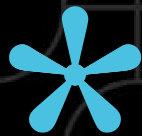
We are inclined to the view that none of the above currently justify a material change in the long-term rate and that the most robust approach to prediction is to leave the (unknowable) long-term rate in place, changing it only very slowly (if at all) and instead to focus on changes that we can foresee on factors applying over the next 15 to 20 years.

Other considerations

Although the focus tends to be on the long-term rate as a single number, the age shape of the long-term rate is potentially as important (see discussion of long-term improvements taper by age in Mark Cooper's article on pages 32-33). There is a legitimate concern that, as the population ages and the focus on older age mortality increases, the age at which the long-term rate starts to taper to zero may itself increase. Indeed, if a radical change to long-term mortality does emerge, it may be that it is the age shape that changes rather than the nominal long-term rate itself. In a similar vein, if confidence in short-term mortality improvements changes, in particular at different ages, then a change may be made to the Convergence Period assumed in any projection (again see Mark Cooper's article on pages 32-33 for further discussion).

Finally, it is a matter of fact that historical mortality improvements have varied materially by gender, age and socio-economic group. This could be taken to imply that different long-term rates should be assumed for different groups – however, this implies that mortality rates will either diverge indefinitely or cross over at some point in the future, both of which are usually viewed as theoretically suspect. Using a common long-term rate instead will mean that differences in mortality rates between groups will persist in the long term, but historical variation has sometimes seen other patterns – in particular a reversion of differentials to historical norms (the classic example being the gap between male and female mortality which increased up to around 1975 and has since decreased). We currently have a situation where the gap in mortality between the better and less well-off has been increasing for at least a decade. Although the consensus appears to be that this gap may continue to grow in the short term, it is worth considering whether a future reconvergence is likely.

"We currently have a situation where the gap in mortality between the better and less well-off has been increasing for at least a decade. Although the consensus appears to be that this gap may continue to grow in the short term, it is worth considering whether a future reconvergence is likely."



The long-term rate: a global perspective

In many respects, the long-term rate is an expression of our lack of knowledge. We use data and models to make judgements and guide our predictions for the foreseeable future. But the long-term rate exists for the unforeseeable future – it applies when the data runs out and we are forced to make an assumption which is not supported by copious information and instead is more a marker of where we believe the right level to be, without any pretence of perfect accuracy. One question then becomes whether this level is the same internationally or differs between nations.

ANDREW HUNT
Pacific Life Re

Andrew is an R&D director at Pacific Life Re, based in London, and has been leading the team developing the mortality trend assumptions globally for the past six years. Before this, he obtained a PhD in Mortality Modelling and Longevity Risk Management from Bayes Business School, which focused on the development of new mortality models and their application. Andrew is also a UK qualified actuary.

The various national actuarial bodies who have developed mortality trend projections have taken differing views, not only on the value of the long-term trend rate, but also how far into the future it applies. These are summarised in the map.

Almost more interesting than the values adopted by the different countries has been the evolution of their thinking on the topic. In general, long-term rate assumptions have converged over time but also been pushed further into the future as the models used to predict the short and medium terms get better.

Canada
In Canada, the MI-2017 assumptions produced by the CIA use a long-term rate of 1.0%pa, which is attained after 20 years.

USA
The Society of Actuaries in the USA has recently adopted a similar approach to the UK, with the latest Mortality Improvements Model having no default long-term rate. However, previous mortality projections from the MP series used a long-term rate of 1.0%pa, which was increased in the 2020 model to 1.35%pa.

UK
In the UK, the CMI Projection Model leaves choosing the long-term rate value up to the user, although most users appear to cluster around 1.5%pa. For age effects, this is reached after around 20 years at the older ages that are material for most users.

Netherlands
The industry standard AG-2020 assumption in the Netherlands is that improvement rates converge to an average of other European countries, but both the rate of convergence and the long-term rate are derived from fitting a model to historic data rather than an explicit assumption in the modelling. Practically, however, this results in a long-term rate of c. 2%pa attained over a 15-20 year period.

Australia & Ireland
Other countries, such as the Republic of Ireland and Australia, do not have standard mortality trend assumptions produced by their actuarial professions. In these cases, views tend to be informed by the assumptions used to project the national population – Ireland uses a long-term rate of 1.5%pa that is reached after 25 years, whereas Australia uses the improvement rates based on extrapolating recent increases in life expectancy.

Our view when setting mortality trend assumptions starts from the premise that the long-term rate will be the same in the various countries we investigate, and we set a high evidentiary threshold for changing this. We believe that many of the long-term drivers of mortality improvements are likely to be common across international boundaries. Improvements in medicine and science are influenced more by the willingness and ability of a country to pay for them than the nationality of their discoverer. Conversely, we have seen epidemics as varied as COVID-19, opioids, HIV/AIDS and obesity cross borders with impunity. While the retreat of globalisation may reduce this significantly and fragment the world into competing and semi-detached blocs, it is highly unlikely to completely remove all transfers of knowledge and behaviour. And practically, countries such as the UK, where there is a need to set a long-term rate assumption because they have significant long-term exposure to demographic risks in the private sector, are likely to remain in the same bloc of like-minded nations in Europe, the Americas and the Pacific.

However, even if we believe that most countries will end up with the same long-term rate of improvements, this leaves plenty of flexibility around when and how quickly this improvement rate is reached. It is worth noting that many of the standard improvement models (such as the CMI's) start blending historic improvement rates to the long-term rate almost immediately after the end of the data, meaning that the choice of the long-term rate affects short-term mortality improvements. We prefer an approach that defers the blending, giving a clearer separation between short, medium and long terms which can have different drivers operating in each.

The dividing line between the short and long terms can also be different between countries. Improvement rates in many western European countries have been bobbling around their long-term averages for several decades, and it feels safer to assume that the long term may not be too far into the future. In contrast there are plenty of countries, especially in eastern Europe or the Far East, that are currently experiencing very rapid increases in life expectancy as they develop and catch up with local pacesetters. In the long term, perhaps, their rates of improvement will drop towards a common long-term rate value, but their long-term may be further into the future than the nations they are closing ground on.

A similar logic applies within countries as well as between them. It is clear that, in the UK and numerous other countries, mortality improvements differ across the socio-economic spectrum, and it seems likely that this will persist into the future (see Matthew Fletcher's article on pages 36-37 for further discussion on how this impacts the choice of long-term rate).

In summary,

when setting an assumption for the long-term rate for an individual country it is helpful to consider the robustness of your long-term rate setting process when applied to other countries as well as the approaches adopted by other actuaries in other countries. Whilst there may be objective reasons for different countries assuming different assumptions (as discussed in this article), often these differences help challenge any "group think" that may have emerged in a domestic setting and therefore this serves as a good way of challenging the judgements that have been made in setting the long-term rate assumption.

COVID-19 AND THE SWAP MARKET:
WHAT DOES THE FUTURE LOOK LIKE?

As we move into the third year of the pandemic, we have got some great news. There are some steady decreases in COVID-19 cases and hospitalisation in both the United States and the United Kingdom. Schools remain open, businesses are coming back to normal, and masks are coming off. We are all hopeful that we are getting to the end of the pandemic.

But will COVID-19 ever completely go away? If not, what does the future look like?

ENDEMIC

One word seems to be trending recently, "ENDEMIC". For example, in the United States, Missouri has announced that the state would shift to an endemic response to COVID-19 starting on April 1st. I believe it is likely to see COVID-19 shift from a pandemic phase to an endemic phase in the US, UK, and many other countries. So, what is "endemic"? It means that COVID-19 will continue to circulate in a particular area or during some time of the year, but at a more static and predictable rate that will not disrupt our daily life. It will likely follow seasonal patterns similar to the flu. However, this does not mean COVID-19 will be harmless, similar to some strains of the flu. We still need to be careful. And many experts expect annual boosters of the COVID-19 vaccine will be recommended, just like the annual flu shot.

In the insurance and reinsurance industry, one related and important question is **what future mortality will look like.** At this moment, there is still no consensus. We have reasons to expect both higher and lower mortality in the future.

SOME ARGUMENTS FOR LOWER FUTURE MORTALITY INCLUDE:

- COVID-19 has resulted in an acceleration of deaths, which means the remaining population is healthier on average than those who died and therefore could be expected to live longer.
- Medical research has accelerated because of the pandemic, and we should expect to see new treatments for various illnesses, improving longevity.
- People will change their behaviour because of COVID-19 (e.g. get more used to wearing masks) leading to a lower spread of illnesses, like influenza in the future.

SOME ARGUMENTS FOR HIGHER FUTURE MORTALITY INCLUDE:

- New strains of the virus could emerge, especially vaccine-resistant strains, which lead to future waves of illness.
- Impacts from people who have been infected by COVID-19 could last into the medium term, affecting their mortality, i.e. Long COVID effects.
- Impacts from non-COVID factors could also lead to higher mortality because of missed medical appointments and other routine screenings, leading to worse outcomes in illnesses like cancer and heart disease.

Unfortunately, there is not enough data to prove whether these theories are right or wrong. And it is also not clear which forces will be stronger over the short, medium and long term. However, one thing we could all agree on is that there is quite an amount of uncertainty in front of us. This means pension schemes or insurance companies that have a large book of annuities and pension risk transfer (PRT) business are facing more volatility from the liability side of the balance sheet than before. Managing this increased uncertainty of future longevity could be difficult.

One hedging tool pensions schemes and PRT insurers have used is the longevity swap or longevity reinsurance, which can be particularly valuable during uncertain times. In the UK market, the longevity risk transfer market has proved to be resilient. Since the start of the pandemic, we have seen that many pension schemes have taken advantage of the competitive longevity reinsurance pricing and executed longevity swap transactions to reduce the amount of uncertainty in their pension obligation. UK pension schemes have transacted £35bn to £40bn of longevity swaps during 2020 and 2021. In addition, there are even more longevity reinsurance transactions done by UK and Dutch insurance companies in support of their pension buy-in and buy-out transactions and as a hedge for their in-force annuity book.

Looking into 2022, with the increasing uncertainty of future longevity and still very competitive pricing from the longevity reinsurance community, we expect that UK pension schemes will continue to use longevity swaps as an important tool on their pension de-risking journey. There has been a large and growing pipeline in this pension scheme swap market. Besides, we also expect that UK buy-in and buy-out market volumes will continue to increase. Some industry consultants estimate the market will grow to the £35bn to £40bn range in 2022, and it is anticipated that this upward trend will continue for the next five to ten years. This means more longevity reinsurance will be needed to support PRT insurers in this market. All signs indicate that the next few years will be very busy in this space.

Overall, we see continued strong momentum in the longevity swap market and believe that the insurance and reinsurance industry is well-positioned to meet the increasing market need.

£40bn

Some industry consultants estimate the market will grow to the £35bn to £40bn range in 2022

JAY WANG
MetLife

Jay is Senior Vice President and head of the Risk Solutions business for MetLife's Retirement division (RIS) in the US. In this role, he has the P&L responsibility for longevity reinsurance solutions, COLI/BOLI, and post-retirement benefits solutions. Besides the leadership of the Risk Solutions business, Wang is also responsible for the strategy and R&D function of the RIS division. This part of the team supports the strategic growth across all RIS product areas, enhances RIS's product design & pricing, and leads product development. Wang joined MetLife in 2019 and led MetLife's entrance into the UK longevity reinsurance market.

Residual risk: THE HEAVY LIFT

Residual risk cover is becoming increasingly popular in the marketplace. The increase in demand is likely down to a couple of reasons:

- The number of buy-outs has increased; strong investment returns has meant that many schemes have reached their endgame earlier than anticipated. As the number of buy-outs has increased, so has the demand for residual risk cover.
- We are seeing more schemes approaching the market with a surplus; when there are surplus assets, residual risk cover is often favoured by the trustee and the sponsor to give peace of mind that small mistakes in their understanding of the data and benefits won't come back to bite them later. Ultimately, why wouldn't you purchase this peace of mind before enhancing benefits or return of surplus?

We have heard about the residual risk cover earlier in the publication (pages 14-17). Here we look at what's involved for the insurer once the decision has been made to include residual risk cover.

The first decision that the trustee will need to make is when they would like the cover to incept. Most insurers will offer the option for the cover to incept at the same time as the bulk annuity policy, or alternatively following the completion of the data cleanse. The desired solution is usually dependant on how "clean/ready" the data is at the point of transacting, and how many cleanse actions the trustee therefore needs to undertake after transacting. It will also determine when the due diligence takes place.

THE "HEAVY LIFT"

The due diligence process:

Insurers need to understand every risk they are taking on. For residual risk cover this will involve an extensive due diligence process. The purpose of due diligence is to fully understand the members' data and true benefit entitlements under the trust deed and rules, so that an insurer may underwrite the risks going forward, as well as to best prepare for the smooth transition and implementation of the buy-out contract.

In general, the due diligence process can be split into three distinctive sections described on the next page. Sections 1 and 2 are always reviewed; however, section 3 is often not reviewed as most schemes choose not to insure legal execution risk (and not all insurers will offer to cover it).

1. LEGAL REVIEW OF BENEFIT ENTITLEMENTS	PROCESS	OUTPUT
To ensure that the benefits the trustee wishes to insure accurately reflect the beneficiaries' legal entitlements under the scheme (plus any additional benefits the trustee wishes to secure).	The insurer and their legal advisers will review the scheme's governing documentation to identify any issues which create uncertainty as to the beneficiaries' legal entitlements. They usually start by reviewing the key scheme documentation – trust deeds and rules and member announcements – but the process will almost inevitably involve looking at additional documentation which is disclosed (such as trustee meeting minutes etc.). The insurer and their legal advisers will work closely together to ensure there is a joined up approach in relation to legal and administration due diligence. They will often also provide updates to the trustee and their advisers throughout the process. If any potentially significant issues are discovered during the process, early communication will give the best possible opportunity (and the most time) to try and resolve any such issues.	The insurer and their legal adviser will generate a mark-up of the benefit specification, which will show any changes which the insurer believes should be made in order to reflect the beneficiaries' entitlements under the scheme.

2. MISSING BENEFICIARIES	PROCESS	OUTPUT
To understand the historical administration of the scheme, in particular in respect of bulk exercises (transfer in/out etc.) in order to form a view of the likelihood of there being missing beneficiaries that could come forward in the future.	The insurer would usually expect to review sufficient information as part of their administration due diligence to form a view on this risk. This could include looking at minutes relating to historical claims, annual accounts to tie up membership numbers etc.	The insurer will use this information to build a view of missing beneficiary risk and use this to inform the overall residual risk premium.

3. LEGAL EXECUTION RISK	PROCESS	OUTPUT
To ensure that all legal documentation affecting benefit entitlements has been validly executed.	The insurers' legal advisers will review the relevant aspects of each document which amends the trust deed and rules of the scheme to check that the various requirements for effective execution are satisfied in relation to each amendment. In this context, validity of execution includes: • Compliance with the scheme's amendment power; • Clear evidence of compliance with the certification/confirmation requirements under section 67 of the Pensions Act 1995 and Pension Schemes Act 1993 respectively; and • execution of all documentation on the trustee's behalf by appropriately authorised signatories and in compliance with any requirements for witnesses.	The insurer and their legal advisers will work together to determine if there are any concerns about the effectiveness of the execution of any document, and any resulting implications for benefits and pricing if so.

DOCUMENTATION

It is really important to have clear documentation as you work through the due diligence process as well as a final summary of findings. The key documents to maintain are:

THE QUERY LOG

This will include the query itself, as well as the category of query, any responses and follow up queries, any follow-up actions and the status of the query (i.e. open or closed).

THE ISSUES LOG

This log maintains the list of issues considered to be due diligence findings for further documentation and consideration. For each issue, the insurer will usually include commentary on the:

- nature of the issue;
- category of issue;
- group(s) affected;
- number of members affected;
- potential quantum;
- further action required; and
- status of the issue and proposed conclusion.

CONCLUSION OPTIONS

Each issue that arises from due diligence would typically be dealt with in one of three ways:

1. NO FURTHER ACTION

Where the issue requires no further cleansing action or information and the insurer agrees to accept any further risk associated with that issue, the issue can be noted and documented as no further action being required.

To the extent that this risk materialises in the future, the insurer would cover the associated additional benefits arising.

2. DATA CLEANSE ITEM

Often a risk will require further action in the form of benefit adjustments or some other form of data cleanse.

The insurer would document such issues in a list of required data cleanse items and the insurer would cover this risk on the condition that the data cleanse action is completed as agreed.

There may or may not be a true-up premium payable later in respect of the cleansed data/benefits, depending on what was agreed at the outset for when the residual risk cover would incept.

3. EXCLUSION

In some cases, there may be issues that the trustee does not wish to correct/cleanse and which the insurer cannot accept.

Such issues would be documented in a list of exclusions, meaning the insurer would not be liable if such a risk crystallises in future.

Hopefully this article gives some insight into what's involved for the insurer when they offer residual risk cover. The scope of this cover is not finalised until the due diligence has been completed and conclusions for each issue have been finalised. Most insurers will have a standard cost for residual risk. As always, good preparation is key to a smooth due diligence process and will result in fewer issues arising that the trustees were unaware of.

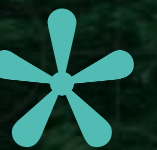
TOM SEECHARAN
Rothesay

Tom joined Rothesay's Business Development team in October 2019 and has over 20 years' experience as a pensions actuary advising schemes and sponsors on assessing and managing pensions risk, with a particular emphasis on pensions risk transfer.
Prior to joining Rothesay, Tom led KPMG in the UK's 20-strong specialist Pensions Risk Settlement team which had experience of helping clients in more than 200 insurance transactions of a range of sizes from £1m to more than £2bn with a combined total of more than £20bn of liabilities.

Residual risk: THE HEAVY LIFT

Legacy phased buy-ins:

Approaching a final transaction



What should trustees of these schemes be thinking about as they approach the end of their journey?

What should you be thinking about*

Using scheme assets to partially remove risk through a buy-in transaction is rightly seen as an effective de-risking tool for many trustees and sponsors.

Carrying out multiple insurance transactions is demonstrably beneficial for many schemes, allowing them to capitalise on favourable market conditions as they arise. In some cases, buy-in transactions allow trustees to improve members' security by reducing risk and improving the scheme's financial position.

Further, many transactions over recent years have been with repeat buyers. The likes of National Grid and TI Group have already secured tranches of members' benefits and developed nimble governance structures to move quickly to take advantage of further favourable pricing opportunities as they arise. This gives insurers greater execution certainty and is therefore beneficial to schemes that have taken an approach of multiple transactions.

As financial positions of many schemes continue to improve, some of those which hold existing buy-ins are preparing for their final transaction. Perhaps they are paving the way for a process which will become more commonplace in the future. So, what should trustees of these schemes be thinking about as they approach the end of their journey?

JOHN BAINES
Aon

John is a Partner in Aon's Risk Settlement Group with 20 years of experience. He has advised on some of the most high-profile transactions of recent years, including the largest ever buy-out (telent, £4.7bn), structuring the 7th (and final!) buy-in transaction for TI Group and buy-ins for Cadbury.

The final approach to market – additional considerations

Pension schemes approaching their final buy-in are likely to be better prepared than first time buyers. Trustees and sponsors will be well versed in what to expect and may have already built up trusted relationships and secured multi-deal contracts with insurance partners. Scheme data may have already been through a robust cleansing process (in preparation for previous buy-ins) and assets are likely to be de-risked in preparation for the final premium payment.

However, there are additional elements to be aware of when approaching a final buy-in. For some schemes, the current insurance market will bear little resemblance to the market at the time of their first buy-in, when residual risk cover was uncommon and the implications of Solvency II were many years from being implemented.

In our experience, trustees with existing buy-ins should pay particular attention to three issues:

1. Residual population

Previous transactions may have covered most or all of a scheme's pensioner liability, leaving an uninsured population of members who haven't yet retired and who are significantly younger than the insured members. This longer-duration liability profile contains more risk and some insurers (and their reinsurance partners) may be wary of taking this on. This could result in a smaller pool of insurers who are willing to quote, or a relatively more expensive final premium.

That said, the bulk annuity market is evolving to meet the challenge of insuring longer duration liabilities, including the increased capability of reinsurers to take on these risks – Asda's £3.8bn transaction with Rothesay included 70% non-pensioner liabilities and broke new ground in this area. We are confident that the market will continue to evolve but, at least for the moment, trustees should consider the residual population when considering their insurance strategy. Where possible, schemes should consider insuring both pensions in payment and non-pensioner members together to avoid the final transaction being too "deferred heavy".

2. Residual risk strategy

A key element to consider for the final transaction is ensuring the trustees can fully discharge their residual risks when the scheme moves to buy-out and eventual wind-up. This can be done in a number of ways, including securing a company indemnity or a trustee indemnity insurance policy. A common approach for medium and large sized schemes is to purchase residual risk cover as part of the bulk annuity contract. This means that if data, benefit or legal issues arise post buy-out, the insurer is typically liable to correct them. Pension schemes which already hold multiple buy-in policies (perhaps with more than one insurer) need to carefully manage this situation across all insurers. There tend to be two potential approaches to this cover:

(a) The insurer providing the final bulk annuity cover provides "wrap around" residual risk cover across all policies; or
(b) Each insurer provides residual risk cover on their own policies.

Each approach needs careful consideration to include consistency of member experience, ensuring there are no gaps in the cover and having a slick but proportionate due diligence process that allows all insurers to understand the risk profile of the scheme. Market experience is developing in all of these areas, making for a more streamlined and competitive market.

Schemes with partial buy-in transactions should develop a residual risk strategy early in their buy-out journey and can take comfort that partial buy-ins are typically not a barrier to obtaining residual risk insurance.

3. The member experience

The insurance market has evolved in recent years – benefits that were previously thought to be ''uninsurable" are no longer so, as Solvency II regulations are better understood and administration solutions are developed. For example, it is common now for insurers to allow schemes to insure a proportion of their cost neutral commutation factors, or to allow members to use linked DC benefits as their first source of scheme tax-free cash at retirement. Schemes should prepare early to understand how all insurance policies can be adopted to benefit from such developments, particularly where they enhance their members' experience of buy-out.

"Each approach needs careful consideration to include consistency of member experience"

Once the final buy-in transaction has taken place, some schemes will start to move towards a full buy-out. At this stage, insurers will issue individual policies to members and the link between a member and the original pension scheme will be severed. It is crucial that trustees and all insurers work together to explain to members what is happening, and that this is done consistently across all policies to avoid a ''two-tier" experience across different insurers.

Final thoughts

A final buy-in transaction and subsequent move to buy-out may present additional challenges to a scheme. Trustees will need to be thinking ahead, beyond the transaction and to the eventual full discharge of their liability to members. If this final stage of the journey is thoroughly prepared for, the experience of securing members' benefits for the rest of their lives will be extremely rewarding for all involved.

illiquid assets

For pension schemes aiming for buy-out, this is likely to involve several years of preparation for the trustees. This might include data cleansing, liability management exercises and finding the right advisers for the final stages of the scheme's journey.

Illiquid assets & deferred premiums

From an investment perspective, the performance of a scheme's assets will be a key driver in reaching the point when buy-out is affordable. At this stage, it is incredibly important that the asset portfolio is a help and not a hindrance to a transaction. Specifically, one of our key aims is to use illiquid assets in the right way and make sure that they do not become a headache for trustees.

EMMA HUDSON
Isio

Emma is a Director in Isio's investments team, who has advised on investment aspects of over £3bn of insurance transactions in the last few years. She advises trustees of schemes ranging from £100m to £10bn in size, and also has a few appointments advising sponsors of large schemes.

Should pension schemes invest in illiquid assets?

Taking a step back, at Isio we believe in the illiquidity premium – i.e. that long-term investors can earn a higher return for committing their money into illiquid assets, versus investing in more liquid areas. In our view, investing in illiquid assets such as private debt, private equity, property or infrastructure also offers diversification versus more traditional return sources (e.g. equity market risk).

However, we also believe that all investment decisions should be rigorously anchored to an investor's long-term objectives. We therefore work with each of our clients to agree a clear long-term objective and target timescale for achieving it, so that any illiquid asset allocation aligns with this.

Where pension schemes are not looking to buy-out or have a time horizon to buy-out of over ten years, we typically recommend investing in illiquid assets to capture the illiquidity premium, selecting assets that align with the scheme's risk/return requirements.

However, for any scheme looking to target buy-out within the next ten years or so, we are more cautious. There could still be scope to capture the illiquidity premium, but this might be in the form of shorter-dated illiquid assets (e.g. private debt funds with a five-year term) or what we term "semi-liquid" funds (e.g. in areas like secured finance) which deal once a quarter.

Why could illiquid assets become a problem?

If we follow the principles laid out above, then a scheme's allocation to illiquid assets should bring diversification and a healthy return, at a sensible stage in their journey.

However, some schemes do find themselves within "striking distance" of buy-out while still holding illiquid assets. Recent market movements (e.g. rising interest rates) have boosted a number of schemes' funding positions, such that they are now closer to buy-out than they expected to be. In some cases, this has prompted discussions about whether the sponsor could provide additional contributions into the scheme to make a buy-out affordable.

In these scenarios, the presence of illiquid assets (which can't always be sold easily) can become a real distraction and challenge in preparing for buy-out. One option that feels obvious is to ask insurers to take on illiquid assets as part of a transaction, but in our view this is often sub-optimal. Because of Solvency II regulations, insurers are very selective about the illiquid assets they invest in and are therefore unlikely to offer the scheme the best "value" pricing for any illiquid assets held.

What are the other options?

1) If the illiquid assets will naturally "run-off" over time (e.g. private debt or equity), wait for this to happen and transact once the overall portfolio is more liquid.

For schemes where there is a strong covenant and/or a mature illiquid asset portfolio, this could be deemed the best value option, especially if there are still other projects to work through ahead of buy-out (e.g. a data cleansing exercise).

In this scenario, trustees should monitor the expected "run-off" profile of their illiquid assets to identify the tipping point at which to start engaging with insurers and tracking insurer pricing. (For our clients, we would use our Opportune platform to do this.)

2) Look for cost effective opportunities to sell the illiquid assets in the secondary market.

Planning is key here, as being a "forced seller" in a short time window is unlikely to result in the best value.

For investments in areas like property or long leases, there might well be the option to simply redeem from the fund. However, it is always worth asking the incumbent investment manager(s) for ideas on potential buyers, in case this could be more cost effective.

For closed ended funds (as used in private debt or equity), most schemes will need to use an experienced broker to sell these. This can yield excellent sale prices but some assets might need to be sold at a discount to their net asset value. Even if this is not the best value approach, it might be acceptable to some schemes – for example, if a small surplus has built up versus anticipated buy-out pricing.

Another approach that we have seen is for the sponsor to consider buying remaining illiquid scheme assets ahead of buy-out. The viability of this for any particular scheme will depend on the sponsor, their balance sheet/risk appetite and the specific illiquid assets held.

3) Explore the potential to pay a deferred premium to insurers.

Under this approach, a scheme would execute a full buy-out transaction, but agree that a portion of the insurance premium will be paid to the insurer once the scheme's illiquid assets fully mature.

This sounds very manageable, but the "catch" here is that we would only expect insurers to offer a deferred premium for a small proportion of the overall payment and it might have an impact on the overall cost of insurance.

In our view, the option to use a deferred premium is an interesting development in the market. However, trustees should compare any potential deferred premium route versus the other two options above. The pros and cons will depend on a range of factors specific to the pension scheme, including the latest funding position, the trustees' and sponsors' appetite for risk and the complexity of any remaining illiquid assets.

What about buy-ins?

Finally, it is important to note that even with an allocation to illiquid assets, schemes could still consider a buy-in of a portion of the liabilities if:

- The scheme would retain sufficient overall liquidity after the buy-in.
- The scheme would also retain a healthy collateral position to support the desired liability hedge ratio (to manage interest rate and inflation risks related to uninsured liabilities).
- The trustees and sponsor are comfortable with the impact that the buy-in will have on their journey plan to achieving buy-out.
- The buy-in can be executed at the pre-agreed target insurance price (which we believe should be set at the outset to ensure good value – and that the above three conditions are achieved).

The above four criteria form the bedrock of the monitoring framework that we use to help clients to make clear decisions about buy-ins along their journey.

Conclusion

To conclude, we are supportive of investing in illiquid assets, but pension scheme trustees need to ensure that new illiquid investments fully align with their investment objectives and time horizon.

If schemes find themselves within striking distance of buy-out earlier than expected, trustees should seek expert help to determine the best "value" approach for dealing with any remaining illiquid assets.

TAX NAVIGATION

TAX ISSUES ON BUY-OUT

"Tax doesn't have to be taxing", or so the old HMRC adage goes. Any trustee in the process of buying-out their pension scheme's benefits with an insurer may, however, disagree. By the time they get to the point of being ready to buy-out, trustees are likely to have had to navigate around various tax tripwires that exist along the way; e.g. when rectifying benefits as part of a data cleanse, or when dealing with GMP equalisation uplifts of benefits (as well the tax issues that arise with historic transfers). In some cases, trustees and sponsors may have also had to consider the tax implications of managing a surplus; or issuing a loan, depending on the premium payment structures involved.

PUSHING THE BUTTON TO BUY-OUT SHOULD BE RELATIVELY SIMPLE...

...but there is a final sting in the tail, as there are certain tax and regulatory issues trustees (and sponsors underwriting the risks of trustees via an indemnity) need to be alive to. These have been under the spotlight in the last couple of years, partly as a result of Brexit and partly as a result of increased adviser scrutiny of the unhelpful gaps in the tax legislation. There is now an increasingly well-trodden path which trustees and their advisers can follow in order to negotiate these issues, however it is important to understand them so the right approach and appropriate advice can be sought in relation to your scheme.

TAX NAVIGATION

STANDARD OR TWO STAGE BUY-OUT?

The key question to determine is how to implement buy-out. The standard approach is for the trustees to give notice under the bulk annuity policy, and the insurer to then issue an individual annuity policy in each member's name directly to the member. The alternative route (often referred to as the "Two Stage Route") differs in that the insurer will issue individual annuity policies in respect of each member in the trustees' name. The trustees then assign the annuity policies (typically by way of a single deed of assignment) to each member. Buy-out occurs at the point this assignment takes effect and the insurer then issues the policy documents (which reference the assignment) to the members.

So which approach should trustees use and what difference does it make?

A key issue here is that the standard route is likely to result in the loss of HMRC fixed protection for pensioner members being bought-out. Whilst the majority of members of a scheme may not have fixed protection, this can be significant for the individuals who do. Fixed protection is used by individuals with substantial pension benefits which exceed the standard lifetime allowance. It protects them by essentially giving them a higher lifetime allowance, i.e. a higher value of pension benefits which they can take without being subject to a lifetime allowance tax charge. Loss of fixed protection means that members could incur substantial tax charges if they need to rely on this protection in the future, for example, if they crystallise any other pension benefits after their fixed protection has been lost. There are different types of fixed protection and this issue applies in the same way across the different types.

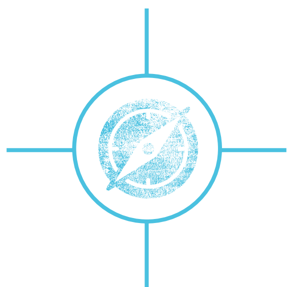
This issue does not impact deferred members who have fixed protection, or members with other forms of tax protection e.g. enhanced protection; only pensioners with fixed protection are impacted. It arises as a result of a gap in the tax legislation. Broadly, to maintain fixed protection, individuals must not transfer their pension benefits to another arrangement except where that is a "permitted transfer" – any other type of transfer will result in loss of the protection. To be a "permitted transfer" it must be made to a registered pension scheme. The tax legislation is clear that an annuity contract for deferred members will be treated as a registered pension scheme, meaning buying-out deferred members' benefits via the standard buy-out route will not result in loss of fixed protection. However, an equivalent provision does not exist for pensioner members. It was thought there might be clever ways to interpret the tax legislation to get around the issue, but HMRC gave unhelpful guidance which largely shut those arguments down. It is therefore difficult to avoid the conclusion that under the standard buy-out route, fixed protection would be lost for pensioners. This gives rise to a potential risk of complaints against the trustees from pensioners who lose their fixed protection through no fault of their own when buy-out occurs. Often the sponsoring employer is underwriting those risks by way of an indemnity for the trustees and so also has a vested interest in finding a solution to this issue.

IMPLEMENTATION & COMMUNICATION

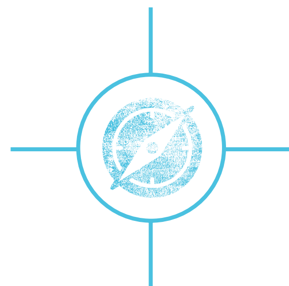
It is now widely accepted in the industry that using the Two Stage Route avoids these issues. Whilst HMRC will not issue binding tax clearance to confirm this, it has issued helpful non-binding commentary which most advisers are now prepared to use to support the advice they give. Technically this is on the basis that the Two Stage Route does not result in a transfer at all, because the issue of policies in the trustees' name is not a transfer. The policies remain assets of the scheme at that point, and the subsequent assignment by the trustees to each member is also not a transfer. The tax legislation is clear that the payments from the assigned policy are deemed to be made from the originating registered pension scheme, even after the scheme has been wound up (so no transfer can have occurred).

This does not necessarily mean all schemes are using the Two Stage Route for all members. We are seeing a variety of approaches being taken, with some trustees using the Two Stage Transfer Route for all members and some insurers having this as their preferred starting position. Other trustees are using the standard route for the majority but adopting the Two Stage Transfer Route for a specified group of members. Some insurers are more flexible and allow trustees to determine their preferred route for different groups. Having the flexibility under the bulk annuity contract to buy-out using either method is now a point to ensure trustees negotiate upfront and any restrictions on this (e.g. where insurer consent is required), should be understood.

Whilst having flexibility is beneficial, deciding who to use for the Two Stage Transfer Route can be tricky. Trustees won't always know which members have fixed protection and they need to decide how far to go in seeking to identify them, including any deferreds with fixed protection who could retire and become pensioners prior to buy-out. Writing out to members to request that information is an option, but how far do you go? Members who could be impacted may wish to seek financial advice, as one other way to ensure they are not impacted would be for them to crystallise any other benefits they have in other schemes before the buy-out. However, that may not fit with their wider retirement planning. Members may feel unhappy they are having to incur the cost of additional financial advice as a result of a buy-out that is being forced upon them. Trustees should consider taking advice on this aspect, as what are reasonable steps to take may differ depending on size of the scheme and the resources available to the trustees. The communications should be managed carefully to avoid creating more issues for the administration team to deal with and to balance the need to explain the issue to members without straying into the realms of giving them financial advice.



CONTINUED



OVERSEAS MEMBERS

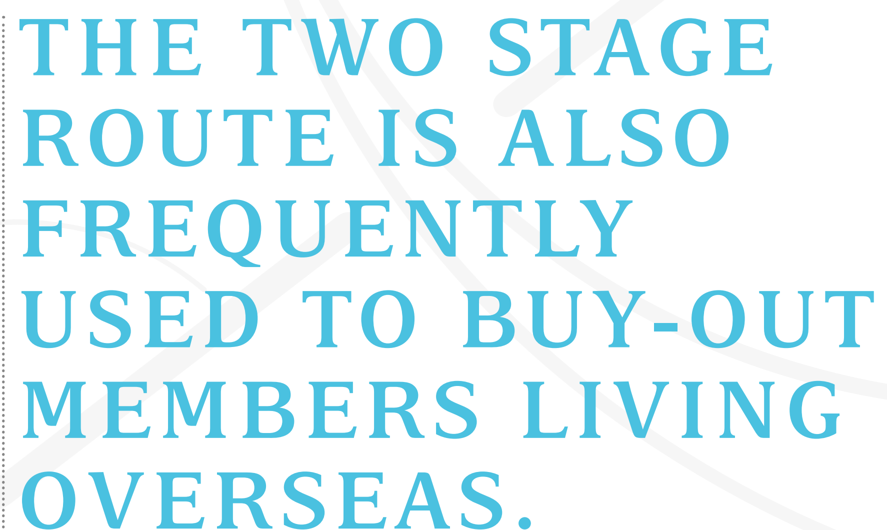
The Two Stage Route is also frequently used to buy-out members living overseas. This mechanism is not new for such members and has traditionally been used to try to ensure that these policies will benefit from coverage via the Financial Services Compensation Scheme (FSCS) in the unlikely event that the insurer becomes insolvent. Most trustees get comfortable that the risks in relation to members having to rely on the FSCS are very low and the protections built into the insurance regime offer material comfort. Nonetheless, trustees often want to ensure they have taken reasonable steps to ensure, in a worst case scenario, that all members would be treated in the same way and avoid the question of having to communicate something slightly different to overseas members as regards their eligibility for FSCS compensation.

Although the FSCS is untested in this context, it is generally accepted that there is a stronger argument that an annuity policy should be eligible for FSCS compensation if the Two Stage Route is followed because the individual annuity policy is initially issued in the trustees' name and so issued to a UK based trustee before being assigned to the overseas member.

There has been greater scrutiny of the implications of this post-Brexit. We have seen some advisers suggest trustees could be exposed to regulatory enforcement action either in the UK or aboard if they use the Two Stage Route to try and preserve FSCS protection for overseas members. In the UK this is based on an argument that under financial services laws in assigning the individual annuity policies on to each member, the trustees could be found to be carrying out a regulated activity under a contract of insurance without the required authorisation or an applicable exemption. If correct, this could mean trustees are committing a criminal offence and may be subject to civil and criminal sanctions.

We do not find the argument compelling in this regard, but clearly any suggestion of criminal sanctions is a cause of concern for trustees. If this issue is raised by a party to a transaction, trustees may want to seek some advice to give them comfort they are not at risk, and having such advice on record would be useful should any regulator raise queries in the future.

TAX NAVIGATION



THE TWO STAGE ROUTE IS ALSO FREQUENTLY USED TO BUY-OUT MEMBERS LIVING OVERSEAS.

PROTECTED PENSION AGE (PPA)

The other area where there can be issues on buy-out is where a scheme has pensioners with a PPA i.e. an ability to retire and take their pension before normal minimum pension age (NMPA) (currently 55). PPAs can be lost on a transfer (including a buy-out) where that transfer does not meet certain requirements. So if you have a pensioner who as at buy-out is still below NMPA, then any future pension payments made post buy-out and up to age 55 are likely to be unauthorised payments. Most bulk annuity contracts will have provisions meaning insurers are not required to pay unauthorised payments. Therefore this is worth checking in your scheme to see if it could apply, and if so, how many members are impacted. Even if nobody is currently impacted (e.g. if all pensioners with a PPA are now over the NMPA) then there is always a risk that a deferred member could seek to retire early just before buy-out and fall into the "at-risk" category. We'd recommend putting the administration team on notice to flag any such cases as they arise. The simplest way around this may be the member postponing taking their pension until after the buy-out has occurred, but other options could be available and it is worth discussing with your insurer.

FINAL ADVICE

The key to managing these issues is to consider early in your buy-out journey whether any of these issues may affect your scheme. If so, it's important to discuss with your advisers how to manage these in a way that will balance the risks to potentially impacted members without adding unnecessary complication to the final step of moving to buy-out.

RACHEL UTTLEY
Addleshaw Goddard

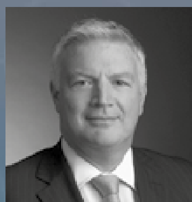
Rachel is a pensions partner at Addleshaw Goddard and advises trustees, corporate and insurers on a wide range of pensions issues, but has a key focus on bulk annuity work. She has advised on over 25 transactions in the last five years including advising the Asda trustees on their £3.8bn transaction with Rothesay.

CONSOLIDATION

IS A GOOD THING – ISN'T IT

The world of Defined Contribution pension saving has seen radical change.

The number of schemes with more than 12 members has decreased from 3,660 to 1,370, with a large proportion of memberships – some 20.7m – now being covered in 36 master trusts. There are many reasons for this rapid rate of consolidation; not least a focus by DWP and TPR on improving governance, which can be poor in smaller DC arrangements, in addition to schemes having to provide a statement demonstrating that they provide value for money ("VFM"). The new obligation for smaller DC schemes to undertake a more detailed VFM assessment going forward may add further to the rate of consolidation.



DAVID FAIRS
The Pensions Regulator

David was appointed Executive Director of Regulatory Policy, Analysis and Advice on 2 July 2018, having previously been a senior partner in KPMG's Pension Practice. He is responsible for the development of policy for TPR and has oversight of TPR's professional advisers including lawyers, actuaries, investment advisers and business analysts.

Master trust authorisation has played a key role in consolidation. The introduction of an authorisation regime in itself caused rationalisation: around two thirds of master trusts that operated prior to authorisation either exited the market or consolidated into authorised master trusts.

The authorisation and supervision regime also provides comfort that master trusts satisfy a number of criteria, including that they are run by fit and proper people, have appropriate systems and processes in place and are financially sustainable. In effect, they provide a safe destination for schemes either wishing to consolidate, encouraged to consolidate, or mandated to consolidate.

Consolidation of smaller DC arrangements into larger arrangements also supports the Government's strategy around climate change and its proposals in relation to Productive Finance and supporting a green economic recovery post-pandemic.

The situation in relation to Defined Benefit ("DB") arrangements is different. DB master trusts operating as a destination for schemes to consolidate have been around for some time as a concept but have been slow to build scale. As a result, they have been slow to deliver benefits to a wide range of schemes such as improved governance, lower administration charges, lower investment costs through efficient investment platforms and indeed opportunities to invest in a broader range of investments. And of course, at present, there is no specific legal definition or authorisation regime for DB master trusts.

We also now have a superfund that has been positively assessed against the criteria set out in our Interim Regime for Superfunds. This has increased the options for trustees looking to take advantage of consolidation.

The emergence of new models has also created new options and has prompted greater focus and a fresh look at DB master trusts. We now have a plethora of structures that drive differing degrees of consolidation and efficiencies in terms of funding and journey plans. No doubt, this has been given impetus by the changing maturity of some DB schemes. Where these schemes were historically set up with the intention to provide an employee benefit, they are now seen by most sponsors first and foremost as a financial obligation, particularly where current employees no longer make up a substantial part of DB memberships.

We are seeing an increase in sole corporate trustee relationships and in some cases those appointments are bringing with them a single provider of other services, creating a very close sole trustee-provider relationship. There is renewed interest in DB master trusts and the creation of DB multi trusts, similar to DB master trusts but with the original legal independent structure of the scheme being maintained. Bespoke capital backed journey plans are also increasingly being promoted as an alternative entrance to superfunds and other risk transfer strategies.

From a regulatory perspective, these present interesting challenges from the point of regulatory arbitrage and from a definitional point of view:

- Whilst there is a legal difference between a DB master trust and a DB multi trust, how different are they in practice? How different are the risks and issues they present?
- With an authorisation regime for DC master trusts, for Collective DC ("CDC") arrangements and a potential authorisation regime for superfunds, does it make sense for there not to be an authorisation regime for DB master trusts?
- If a DB master trust cooperates with a Private Equity firm that provides downside protection and fiduciary management services, when does it become in effect a superfund?
- If a capital backed journey plan is operated by the same consultancy firm and asset provider multiple times, at what point does the combination constitute a superfund?

It is clear that from our perspective, the landscape is becoming more complex and challenging, but there are opportunities to improve the DB landscape and outcome for savers. The same is true from the perspective of trustees. There are more options and opportunities for schemes to implement a solution that is appropriate to their needs and circumstances. It will create the opportunity to improve governance, take advantage of economies of scale, or to access new investment opportunities, external support or protection. This, we think, is a good thing.

It could be said that the DB market place is ripe for consolidation. There are now around 5,500 DB schemes but 80% of them have less than 1,000 members. The economic climate means that moving to a consolidation vehicle or taking advantage of some of the other models beginning to emerge makes good sense for the employer, the scheme and its savers.

But a market that is consolidating in this way and introducing investor capital into the management of pension schemes will increase the potential for conflicts of interest. At the moment, there are 5,500 scheme actuary appointments, audit appointments and administration appointments. As the market consolidates, so mandates will become bigger but fewer in number. Commercial interests might be at odds with optimising saver outcomes.

Undoubtedly, there will be opportunities where saver and commercial interests align and more efficient mechanisms to fund pensions emerge. It is increasingly important for trustees to be alert to commercial conflicts, ask the right questions to be able to interrogate and understand what different options may mean for their scheme and have advisers in place that are able to provide independent and impartial advice to support this. We have published guidance to employers and trustees considering a superfund, but that is just one aspect of the ever changing and complex landscape. We recognise that there is room for us to support trustees further in how to approach and judge all the options available to them.

So is consolidation a good thing? On balance, yes, if it delivers greater saver protection through improved security, governance and efficiencies. As a regulator, we want to support and encourage innovation, but we also need to ensure the interests of savers is paramount and that trustees are well placed to make decisions in this area. To do that, we need to continue to engage with government and industry as the landscape develops; we need to support trustees to help ensure they have the tools they need; and we need to adapt the way we supervise, regulate and take action.

So is consolidation a good thing? On balance, yes, if it delivers greater saver protection through improved security, governance and efficiencies.

A HIGH INFLATION MARKET:

What this means for pension schemes

In June 2022 the Bank of England’s Monetary Policy Committee increased its inflation forecasts once again, predicting CPI will now surpass 11% by October 2022.

It was the latest in a series of uplifts as inflation continues to rise and the Bank responds with increases to the base rate.

A high inflation market – what this means for pension schemes

While rising prices are unwelcome news for most people, particularly those with fixed income sources like pensions, it's not so gloomy for the funding position of defined benefit pension schemes.

In many cases, pension scheme trustees will welcome a bump in their funding positions that could drive a strategic review of their long-term plans.

There are three potential benefits that the current inflationary environment could bring to pension schemes and their members:

1 IMPROVED SCHEME FUNDING:

While pension increases for many funds are capped at 5%pa, investment returns are not. At a time of high inflation, investment returns and index-linked assets have the potential to exceed increases in pension payments, thereby improving schemes' overall funding positions. The September inflation print is all-important for many schemes. It is at this point that the anticipated funding gains will be realised and, while there remains some uncertainty over the final level, it is clear that absent a dramatic change it will be significantly in excess of 5%.

2 EARLY RETIREMENT FACTORS:

One area where inflation is less likely to be capped is deferred revaluation. Therefore, any member who chooses to retire early may see a smaller reduction in their pension than would have been the case previously, as trustees give them the value of the full deferred revaluation foregone by early retirement. This will particularly affect components of pensions that do not increase once in payment, and for members with these types of pensions, retiring one or two years early may result in an uplift rather than a reduction to achieve cost-neutrality.

3 REDUCED STRAIN ON THE PPF:

With improved scheme funding, PPF funding levels should also improve - perhaps by an even greater extent given PPF pension increases are capped at 2.5%pa. The risk that the lifeboat will be placed under strain by a weaker economy is also reduced because there are more schemes funded above PPF levels. As a result, any levy due should reduce, with both an immediate effect and (all else being equal) further benefits over time.

WHAT THAT MEANS FOR TRUSTEES

Improving funding levels is good news for the sector. It boosts confidence that schemes can meet their commitments in full to members. For a number of schemes, the journey to buy-out will be much quicker and, for some, it puts the option of a buy-out on the table for the first time. In both cases, improved funding has the potential to enhance members' financial security and protect their futures for the long-term.

A reduced reliance on the PPF alongside its own improved funding position will also create a stronger safety-net for the schemes that do fall into it.

It's therefore a good time for schemes and trustees to review their immediate hedging position and long-term strategy to take into consideration the changing economic backdrop and whether it has opened up new options.

A low-for-long rates environment and sub-5% inflation has been the "norm" since the 2004 Pensions Act ignited the pension de-risking sector – the same funding objectives and endgame plans may no longer be appropriate in the midst of double-digit inflation.

Schemes should ensure they understand how inflation impacts them and whether they should adjust their objectives, be that self-sufficiency, consolidation or buy-out.

The inevitable question is:

"what should trustees and scheme managers actually be doing to capitalise on this inflationary economic environment?"

Below are three immediate actions schemes should consider:

1
Check the scheme's factors – see how the scheme is structured and whether factors need adjusting for both higher interest rates and higher inflation.

2
Consider your investment strategy in light of improving funding positions – existing asset strategies may no longer be best suited to the current funding objectives and may benefit from, for example, a bigger focus on liquidity.

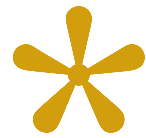
3
Finally, look at inflation-hedging positions – clearly the markets are changing rapidly, so hedging strategies may need to be reviewed and possibly adjusted to bring in line with caps on inflation.

SAMMY COOPER-SMITH
Rothesay

Sammy is Head of Business Development at Rothesay. Sammy joined Rothesay in 2011 and is responsible for new business origination and marketing to defined benefit pension schemes and insurance companies. At Rothesay, Sammy has played a lead role in transactions with the pension funds of National Grid, telent, Asda and Allied Domecq among others as well as the reinsurance of the Prudential, Zurich Assurance and Aegon annuity portfolios. Prior to joining Rothesay, Sammy was at Paternoster which Rothesay acquired in 2011. He started his career at Prudential.

A Trustee perspective

Six questions on endgame planning



Endgame journey planning – A Trustee perspective

TIZIANA PERRELLA
Dalriada Trustees

Tiziana is a lead trustee with Dalriada Trustees Limited. A qualified actuary, she has broad pensions experience, with specific expertise in risk settlement including being lead adviser on over 200 buy-ins and buy-outs in the last 20 years, in respect of transactions ranging in size from sub £10m to £4bn in size. Prior to joining Dalriada, Tiziana was an Associate Partner within Aon's Risk Settlement Group, having joined from JLT where she was head of the bulk annuities team. Tiziana has over 20 years' experience of working exclusively within UK occupational pensions.

1. WHAT ARE TRUSTEE BOARDS CURRENTLY TALKING ABOUT IN RELATION TO ENDGAME JOURNEY PLANNING?

The endgame for DB schemes is generally accepted to be a transfer of liabilities, followed by a scheme wind-up. For most schemes with a current objective of self-sufficiency, this is just seen as a partial step towards the real objective of buy-out.

With improving funding levels, and market volatility creating pricing opportunities in the bulk annuity market, more schemes than ever are close to buy-out if we just look at affordability. Realistically though, it is only a small minority of schemes which would be able to transact quickly if the opportunity arose. Incomplete data and the lack of a legally signed off benefit specification are big hurdles.

Many schemes start preparatory work on a broking specification just to discover that there is an equalisation issue and that rectification work is required. The difficulty then becomes sourcing the required administrative support in respect of the exercise – administration teams are really stretched at the moment. Investment and governance are two other areas that usually require trustee attention – even well-hedged schemes are likely to require tweaks on the way to settlement and sponsors need to be engaged with.

Finally, the availability of alternative solutions to a traditional buy-out mean that trustees need to be fully up to date with market developments – not just what is on offer, but also what advice is required and where this should be sought. The formal appointment of a trusted settlement adviser as early as possible will lead to better decisions and better outcomes for members.

2. WHAT ARE YOUR CURRENT VIEWS OF THE BUY-OUT MARKET?

The market seems to be very active at the moment, although not quite at the manic levels we saw towards the end of 2021. It is a mature market with experienced players – insurers are easy to engage with, very open about what they can and cannot do and happy to assist trustees if they can, and will even act as a sounding board in respect of any decisions which may impact future insurer appetite and terms for a given scheme.

The market is segmented to an extent, by size and profile first and then by contractual features on offer. This is not a bad thing as insurers are quite clear on these aspects and how their propositions may change over time.

It is very pleasing to see that there are a number of providers still very active in the sub £50m space. I have not yet come across a well-prepared scheme with sensible transaction metrics being unable to obtain at least one competitive quotation and I very much hope this continues to be the case.

3. HOW DO YOU EXPECT THE MARKET TO EVOLVE IN THE FUTURE?

While it would be great to see the market expand with further entrants, I can't see this being likely in the short term given some of the barriers to entry, including human resource considerations and inherent limits in the availability of longevity reinsurance. A move to make broking processes and transactions simpler is already under way via pre-negotiated standard contracts, one-round (and potentially one-insurer) processes and I can see this evolving further, for example with the development of market-standard data and benefit specifications. The complexity of a lot of pension schemes will naturally limit the level of standardisation which is achievable. I expect insurers will be able to offer more robust indicative pricing and price monitoring against a scheme's investment portfolio – some insurers are slightly ahead of the curve on this.

4. HOW IMPORTANT IS ESG IN TRUSTEE DECISION MAKING – AND DO YOU FEEL YOU GET ENOUGH INFORMATION TO MAKE AN INFORMED DECISION?

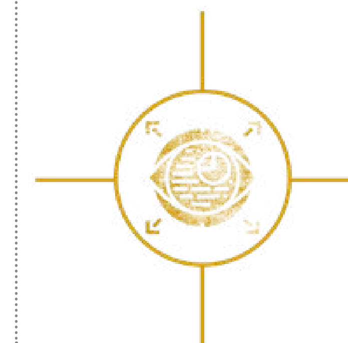
ESG factors have increased enormously in visibility and importance for trustee decision making over the last few years, which is of course a positive development. ESG considerations are particularly relevant when it comes to risk settlement given that this is the final destination for scheme assets – therefore, making the "right" decision is particularly important.

We are certainly not at the point where ESG considerations are key in decision-making, however. Expected returns, or price in the case of a bulk annuity transaction, remains the key selection criterion and I cannot see this changing. ESG factors may be helpful in differentiating providers and making a decision when there are multiple counterparties delivering the required terms.

Insurers are very aware that this is an aspect trustees will look at, and are increasingly developing reporting measures which they can share with advisers to address any information gap. As the information is not available on a consistent basis it does needs some interpretation; but it is still very helpful to trustees. Bulk annuity providers do have good stories to tell generally, as some of the assets they have been investing in to diversify their portfolios and offer better yields to pension schemes have implicit sustainability credentials (e.g. social housing, wind farms).

5. WHAT ARE THE MOST IMPORTANT THINGS TO GET RIGHT?

My answer to this would be "the process", as this encapsulates all the other areas of preparation that need to be addressed – data, benefits, assets and governance. By "process" I mean discussing and agreeing the endgame with the various stakeholders; understanding the market and the segment of it relevant to each specific scheme; understanding the history of the scheme, and the main areas of risk; appointing the right advisers and engaging with the market at the right time; completing projects once they have been started; obtaining detailed advice as required but choosing pragmatism where it makes sense to do so. Objectives need to be clear and measurable and project plans need to be set out in a way that makes it easy to report against them. This type of preparation will make trustee boards nimble and able to move quickly if this is assessed to be beneficial – which historically has been a major challenge for pension schemes.



6. WHAT MARKET DEVELOPMENTS WOULD YOU LIKE TO SEE IN THE FUTURE?

Anything that assists schemes in securing their liabilities and makes life easier for both trustee boards and the insurers themselves would be welcomed. Examples could include: ability to offer GMP equalisation via dual records to schemes of all sizes; an element of premium deferral as much as regulations will allow; wider availability of pre-negotiated contracts; ability to match scheme underpins; price locks that more closely reflect scheme assets; more extensive price monitoring available to well-funded schemes who engage with the market; wider availability of residual risk cover, potentially on standard terms where feasible. Simpler post transaction implementation processes would also be great.

*

Endgame journey planning – A Trustee perspective

NADEEM LADHA
20-20 Trustee Services

Nadeem is a professional trustee and leads the 20-20 Trustees' Risk Transfer Team. Nadeem, a qualified actuary and an ex-strategic advisor at PwC and Hymans Robertson, focuses on endgame journey planning, complex funding and investment situations, pensions de-risking and risk transfer transactions including buy-ins and buy-outs.

1. WHAT ARE TRUSTEE BOARDS CURRENTLY TALKING ABOUT IN RELATION TO ENDGAME JOURNEY PLANNING?

Trustee boards are needing to navigate their way through a huge variety of endgame planning, particularly where insurance settlement is involved. As well as the obvious data and legal readiness aspects, which are now a well understood aspect, planning needs to involve commercial and strategic elements at an early stage.

Assets need to be deal-ready at the right time, so understanding and dealing with liquidity constraints efficiently is important, but this conversation in particular needs to begin many years before the expected risk transfer date as illiquid assets can be a real issue otherwise without careful planning. However, aiming for maximum liquidity at any cost doesn't make a huge amount of sense either if the scheme is still a few years away, as the trustee and sponsor may be giving up huge amounts of value.

Turning our focus to members and their options; ensuring valuable options are available, communicated and set at the right level is also important for all stakeholders, members, the sponsor and the insurer. We are seeing a huge trend towards providing members with signposted, well-communicated and advised options so that they both engage with their valuable pension pots and make the right decisions for them given the members' own circumstances. It is rare that keeping quiet about members' options at retirement or before a buy-out is a good thing.

Linked to members and their options, are the scheme's factors. There are often differences between the average scheme's factors (such as commutation) and insurers' factors. Working on a "factors journey" to sit along with the other elements of endgame planning helps to prevent a cliff edge scenario where, following the insurer transaction, these could change dramatically overnight.

One other aspect of strategic planning that has really come to the fore in recent years is how to execute an efficient yet controlled path to a buy-out. With a huge variety of tools available to trustees and sponsors, it makes sense to explore which of these make a difference to the outcome. We've also seen a significant shift from both trustees and sponsors in ensuring that schemes don't end up dramatically overfunded, resulting in the surplus being taxed heavily. This isn't a great outcome for any party, and there are simple ways to avoid this situation. All these points take thought and planning.

2. WHAT ARE YOUR CURRENT VIEWS OF THE BUY-OUT MARKET?

The buy-out market continues to evolve, with newer players in the market hungry to demonstrate their credibility. At the same time, the types and sizes of scheme liabilities and assets that insurers are interested in change all the time. This is why we believe that strong relationships between the insurers and trustees will become more important, particularly over the next six to seven years as the demand peak hits us.

Clearly, the insurance market isn't a monolith, and nuances in investment strategy of the insurer, capital availability, ownership structure and governance structure all play a part in how trustees should think about which insurers to approach, when and how. The first step is understanding which insurers would be keen on your scheme.

The supply-demand dynamics continue to drive how trustees and sponsors approach the insurance market. However, we do note that sometimes there is a good deal to be had by working with insurers closely and understanding when they are best placed to offer good terms.

One thing that is common across all insurers is the recognition that members need to be front of mind. This is great to see, and critical for trustees' peace of mind.

3. HOW DO YOU EXPECT THE MARKET TO EVOLVE IN THE FUTURE?

Insurance markets historically have evolved remarkably as pension scheme demand has shifted but also as longevity risk market dynamics have changed, particularly from those reinsurers outside of the UK. This has been very noticeable. However, the most significant drivers have been parties interested in putting their capital to work in the UK pensions sector and changes to insurance and capital regulation.

It hasn't gone unnoticed to trustees close to the insurance market that both the PRA and government are thinking very hard about the balance between the attractiveness of the UK insurance market and financial security. They will of course find a suitable balance over the coming months, but wherever the status quo lands, two things are for certain. Firstly, there could well be some sort of shift in market dynamics. This may be a change in capacity, a shift in how longevity is insured and a shift in pricing, particularly for less mature pension schemes and their sponsors. It wouldn't surprise us at all if new players enter the market, but the preference for these new entrants are likely to be as nuanced as the preferences for the current insurers in the market. Understanding the strengths and weaknesses of these new players will be important and it will be interesting to see how quickly they are able to get up to speed on operational aspects of delivering buy-outs to the market and how they position their member-focused brand.

4. HOW IMPORTANT IS ESG IN TRUSTEE DECISION MAKING – AND DO YOU FEEL YOU GET ENOUGH INFORMATION TO MAKE AN INFORMED DECISION?

I suspect there will be a race in the insurance market to stand out on ESG – and we are already seeing this. Clearly ESG is an important aspect to be considered, whether we are talking about ensuring good governance at the insurer level in relation to Treating Customers Fairly or within their asset portfolios. However, it will be equally as important to see real movement on portfolio decarbonisation and social impact. Insurers will be around much longer than most pension schemes, and as such have even more reason to focus hard on ensuring their business and their investments are sustainable in relation to ESG. Trustees need to look past the very prominent headlines of the day, but I do believe that given the immense level of focus and attention we are seeing in this area, trustees will begin to see a recognisable shift across the insurance market. The Task Force on Climate-related Financial Disclosures will require more and more schemes to improve and increase reporting of climate-related financial information. Trustees will increasingly be looking for insurers to reflect their approaches and beliefs.

5. WHAT ARE THE MOST IMPORTANT THINGS TO GET RIGHT?

There are so many aspects to a successful risk transfer programme, and whether it's value, data, risk management or execution, none of these areas can be relegated to sit under the "less important" banner. Saying that, amongst the complexity of parallel workstreams, asset transfers, deal negotiations, data cleansing and benefit rectification, we must focus on the communication journey with our members. With many categories of membership all with their own nuances and differences, planning a well-thought-out communication strategy to members will be the difference between members being confused and potentially concerned about the process, to understanding what is happening to their pension and seeing the value for themselves.

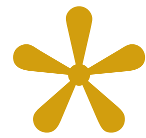
6. WHAT MARKET DEVELOPMENTS WOULD YOU LIKE TO SEE IN THE FUTURE?

From a trustee and sponsor perspective, I would like to see developments focused on three main areas: certainty of value, operational simplicity and member engagement.

Certainty of value used to mean getting the best price and locking in to that price as quickly and as effectively as possible. That is all well and good with an imminent deal and a relatively simple asset portfolio, but it would be lovely to see some further innovation to provide certainty well before the date that a deal is struck – this might be investment support, some underpinning of terms over a longer period or a way to help trustees shift assets in the most cost effective way.

Operationally, different insurers have slightly different approaches for getting the scheme to buy-in and then to buy-out. Standardisation has commonly been looked into, but is hard to achieve across the board in reality. I would love to see insurers offering trustee boards increased operational support to really help to streamline the processes. Insurers know best how to run a process in a way which fits their needs. If they could proactively offer some additional resource with insurer-side knowledge to support administrators, lawyers, trustees and pensions managers, I believe the process would improve remarkably. Some insurers do this as a matter of course already, and we definitely see better outcomes in these cases.

Insurers are actually pretty good when it comes to communicating with members. They have had to be, as it is at the forefront of trustees' minds when selecting an insurer. But as engagement and expectations increase, and more members end up with their pension being secured with an insurance company, insurers must continue to innovate to ensure members understand and value the benefits they are receiving. Online portals in the DC space have been evolving steadily over the years and are increasingly app-based, providing individuals with instant access to their DC pension savings. The DB world is slowly catching up, with dashboards on the way. It is important that this increased digital access to members' pensions is reflected in the post buy-out insurer world.



Endgame journey planning – A Trustee perspective

AKASH ROOPRAI
Independent Trustee Services Limited

With well over 25 years' pensions experience, Akash, a qualified actuary, is a Director at ITS leading on a range of pension schemes with a variety of sizes and circumstances, and he is Practice Lead at ITS for Sole Trusteeship.

Akash has wide industry experience at leading consultancies and at an insurer. He has advised trustees and corporates of all sizes on their pensions issues in a variety of sectors. He has deep knowledge of pension risk management/bulk annuities, having led on some ground-breaking transactions and is experienced in GMP equalisation matters as well as data and administration. He has a wide industry network. Akash is working on a variety of risk transfer projects for his clients, such as buy-ins, buy-outs and wind-ups.

Akash chairs the Institute and Faculty of Actuaries Bulk Annuities and Longevity Swaps Member Interest Group and the data sub-group of the industry wide GMP Equalisation Working Group set up by PASA.

1. WHAT ARE TRUSTEE BOARDS CURRENTLY TALKING ABOUT IN RELATION TO ENDGAME JOURNEY PLANNING?

Longer term or earlier planning, a few years from the endgame. The reluctance is that trustees can't buy-out straight away, so why bother doing this now? But our view would be if the market does turn in your favour, then you want to be ready to take advantage of it. Getting your house in order now is a good investment, it's never going to be wasted effort and it is good governance.

Thinking more holistically about the risks, including data to ensure it meets the high-quality threshold required for settlement transactions. Also, ensuring documentation is up-to-date and complete and checking for any barriers or potential challenges in the scheme's trust deed and rules. This can be done well ahead of the proposed transaction.

Setting up a Joint Working Group ("JWG") at the outset of a project. With trustee, employer and key advisers and appointing a journey planning consultant for the whole journey. Ideally this person should be independent of the business as usual advisory team, so that they can focus on co-ordinating the advisory team. This helps ensure all parties are aligned at key decision points enabling any issues to be resolved collaboratively. This also increases credibility with the insurers in a market that continues to transact at record levels.

Having a dynamic plan that can react to changing external environments/shocks.

2. WHAT ARE YOUR CURRENT VIEWS OF THE BUY-OUT MARKET?

The current buy-out market continues to be good value. It is mature, yet still innovative and sophisticated. It has become more complex, with having to consider insurer appetites as they vary over time, reinsurance availability and pricing, asset sourcing by insurers, Solvency II changes and alternative solutions.

Most market participants continue to predict sustained high levels of activity fuelled by pent up demand for settlement emerging gradually as schemes reach affordability. Inevitably this will be more lumpy than smooth and there are bound to be times that are extremely busy and some that are relatively quieter. This means being ready to transact, often before affordability is confirmed, is beneficial to enable arising opportunities to be taken. It will also be increasingly important to be aware of the market environment and the position of a "buyers' or sellers' market" at different times, to help optimal market approach timing. In a frenetic market, sometimes smaller schemes can be crowded out. If bringing a smaller scheme to market, it may be appropriate to work out how to best position it for an efficient process whilst still obtaining decent pricing.

The innovation has brought not only a greater number of risk transfer/settlement solutions (superfunds, more insurance products, covenant enhancement (via capital)), but also more effective ways to access the market via provider platforms, better approximate pricing by insurers and fiduciary solutions that better target a move to buy-out than those previously available.

3. HOW DO YOU EXPECT THE MARKET TO EVOLVE IN THE FUTURE?

The market is likely to grow with demand, but there could be step changes that cause an imbalance in either supply or demand. Schemes will settle with a range of the alternative solutions, such as those described above, but buy-in/out will still predominate. The expectation is that there will be further innovations in the market, partly depending on where Solvency II ends up.

We may achieve the Holy Grail of standardised data and benefits, but this has been aspirational for years and remains to be resolved.

4. HOW IMPORTANT IS ESG IN TRUSTEE DECISION MAKING – AND DO YOU FEEL YOU GET ENOUGH INFORMATION TO MAKE AN INFORMED DECISION?

Price remains and is likely to continue to remain the most important factor by a large margin.

However, the way in which pension funds are invested impacts the future of our economy, environment and society. Therefore, ESG is getting an increasing amount of trustee focus and will be part of the decision making in selecting a provider.

From a buyer's perspective it is easy to get deluged in metrics and other information on ESG. The key things we like to see are simple, clear targets with tangible actions over the short, medium and long term that link directly to any targets/aims.

The expectation in the market is that at the very least insurers will get this "right" and be reasonably consistent between themselves. Other settlement providers will need to keep up or they may experience reduced demand.

5. WHAT ARE THE MOST IMPORTANT THINGS TO GET RIGHT?

Data, Data, Data! A detailed data-focused journey plan to improve governance, record-keeping and prepare for risk management projects in the longer term is essential. When projects become more complicated than necessary or don't work, it is often data that is the issue.

Establishing a robust project set-up early in the process will influence the smooth running of endgame journey planning. For example, a JWG with defined roles and responsibilities including trustee and employer, advisory team and a journey planning consultant. Selecting members of the JWG with the right skill sets and experience is paramount.

Together the JWG can:

- Define clear objectives and timings between planning and endgame.
- Identify and resolve any document and benefit issues early.
- Develop a focused asset strategy.
- Robustly approach holistic risk assessment, identifying what all the risks are and where each is going to end up.

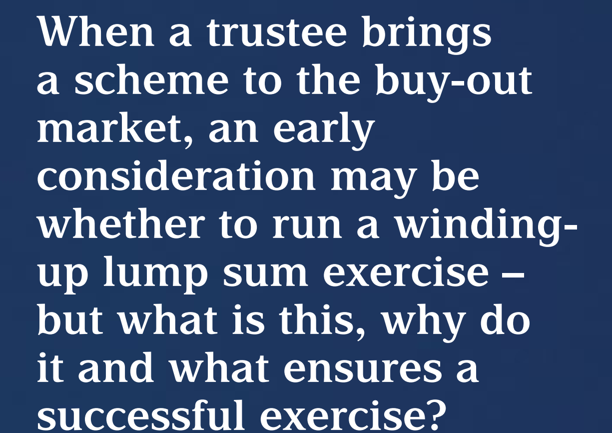
The critical consideration is that the chosen solution must be aligned to the overarching endgame objectives agreed between the sponsor and the trustee, and fully deliver the objectives for member benefits.

6. WHAT MARKET DEVELOPMENTS WOULD YOU LIKE TO SEE IN THE FUTURE?

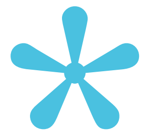
- A return of phased payments (it does still exist but is more cumbersome than pre-Solvency II).
- Common approaches for data and benefits across providers (as much as is possible).
- Improved management of data through the process.
- An enhanced range of residual risk insurance at a "proper" price reflecting the risk – with appropriate underwriting and pricing.

WINDING-UP LUMP SUMS*

A TRUSTEE'S PARTING GIFT



When a trustee brings a scheme to the buy-out market, an early consideration may be whether to run a winding-up lump sum exercise – but what is this, why do it and what ensures a successful exercise?



A WINDING-UP LUMP SUM EXERCISE (WULS)

is a one-off opportunity that arises as a result of winding-up an occupational pension scheme. UK legislation allows trustees to settle liabilities by offering members with small pensions a lump sum payment (up to certain limits) in exchange for their regular pension payment, provided it extinguishes all benefits in the scheme (including any contingent pension payable on death).

What makes a WULS exercise so special is there is no minimum age requirement and the value of other pension rights doesn't need to be taken into account (so long as the member has enough Lifetime Allowance available). So a trustee can offer this lump sum option to all deferred and pensioner members whose total benefits are valued below the limit set by the government (currently £18,000).

But running a WULS exercise takes planning and resource on all sides: data analysis, preparing calculations, member communication and administering the process will all place demands on the trustee, its advisers and the scheme's administrator, as well as the insurer – at a time when there is probably already plenty of ongoing activity to prepare the scheme for moving to buy-out…

…so why do it?

Members

get to access their pension in a way that could be more beneficial to them, giving them more freedom and flexibility to manage their own finances. And for deferred members, 25% of the lump sum would be paid tax free.

Trustees

are now focussed on the last stage of serving the scheme and find this a compelling proposition to offer their members. A WULS exercise may also play a role in enabling the buy-out in the first place as it can be used to reduce the premium paid to an insurer and potentially the additional funding required from the sponsor. Like other liability management exercises, a WULS exercise would be expected to discharge liabilities at a value lower than the premium that would otherwise be paid. Insurers can underwrite a WULS exercise in their pricing calculations, essentially offering a discount to the premium on the basis of an exercise being fulfilled (and making assumptions about member take up). The financial benefit of a WULS exercise will however vary from scheme to scheme, depending on a scheme's demographic profile, and the proportion of the membership that would be eligible for the lump sum.

Insurers

stand to reduce the number of members becoming policyholders, thereby stripping out small pensions which come with a disproportionately high administration cost, and simplifying ongoing administration and operations activities.

Sounds like a win-win?

Yes, potentially - provided it is underpinned by careful planning to ensure the exercise runs smoothly and fits in with the trustee's primary objective of reaching buy-out within their target timescale. Let's look at some key factors to consider when assessing the feasibility and planning an exercise.

1. Agree your milestones.

Determine when you ultimately want to buy-out and work backwards. Is there sufficient time, in parallel with all the other buy-out activities, to prepare the data and calculations, communicate with members and make payments before making your buy-out request? Is it OK for the buy-out date to move if needed? When considering this it's worth remembering that if the exercise has been underwritten by an insurer as part of the premium, they may also have some requirements around timings; for example, the length of time members must be given to consider the option or when the exercise takes place.

2. Engage with advisers.

You will need additional support from your actuarial and legal advisers to get this right and it could be particularly burdensome for your administrator to complete the exercise – is the resource available and at the right time (and not to the detriment of other buy-out activities)?

3. Know your scheme.

Are there Additional Voluntary Contributions or other benefit quirks that could impact on WULS eligibility or calculations? Are there multiple sections that members have service across? Do you have any overseas members?

4. Agree the parameters and conditions the exercise should operate within.

How will you deal with deaths that occur after sending an offer; what happens if members respond outside of the offer window; what about older and/or vulnerable members?

5. Plan how you will support your members.

The overall success of the exercise could rest on the member communications – building in enough time to prepare these so members feel supported in making a decision that is right for them will enhance the member experience, whether they ultimately take the offer or not.

This could be a trustee board's last interaction with their members, so it is worth getting right.

Anyone that has already spent any time considering a buy-in or buy-out will know 'preparation is key' to get the best outcome – a WULS exercise is no different, so mapping out a detailed project plan for the exercise in the context of your overall buy-out plan is paramount.

When deciding whether to do a WULS exercise, a trustee will need to weigh up the impact on cost, timescale, and member experience. When planned well, a WULS exercise can be a hugely valuable option to offer their members; as well as being a useful tool, alongside others, to help trustees achieve their ultimate goal of buying out the scheme.

SHONA DAVIES
Rothesay

Shona joined Rothesay's transition team in 2021, having previously worked as a pensions consultant at Mercer, helping clients manage their pensions risk. Her role is focused on the post execution activities of new liability transactions. Shona is a Fellow of the Institute of Actuaries.

MALLOW STREET SURVEY RESULTS

BUY-OUT PREPAREDNESS ACCELERATES SIGNIFICANTLY AS FUNDING LEVELS IMPROVE

The survey results in this publication are based on a survey of 69 pension schemes. Key statistics on the participating schemes are detailed here.

This year our survey results indicate that schemes are continuing to improve their funding levels.

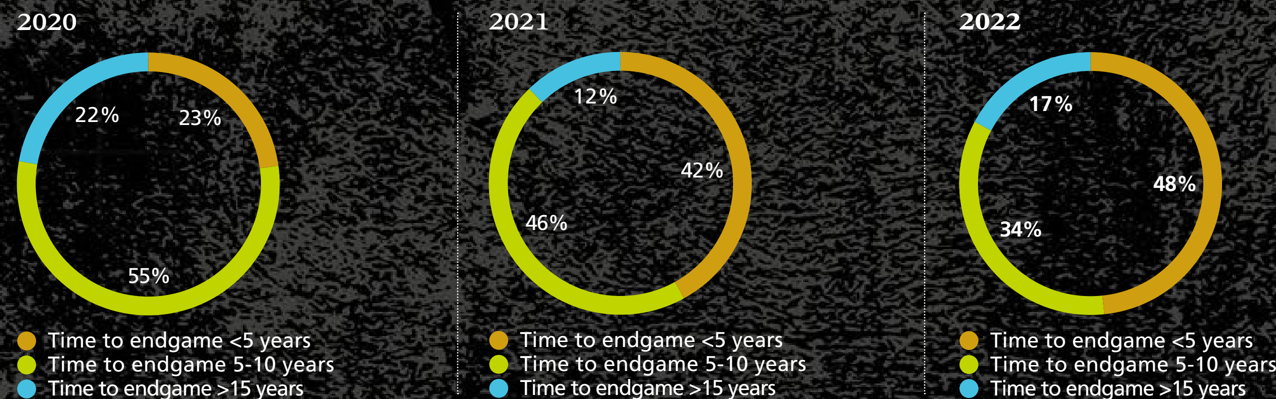
Well-funded schemes nearing buy-out are reducing their illiquid exposure and conducting data checks, yet some are sufficiently prepared for a buy-out and plan to seek out a counterparty this year. In comparison, schemes which are further behind are working with the sponsor to speed up decision making and close their funding gap.

Schemes on a path to low sponsor dependency are improving their funding levels too – but many are allocating more to illiquid assets and using longevity swaps and cashflow-generating assets as part of their de-risking.

Our most recent survey results also reveal that, although insurance pricing is becoming more affordable, many small schemes remain concerned that they will not be able to do a transaction with an insurer.

Many schemes are within reach of buy-out

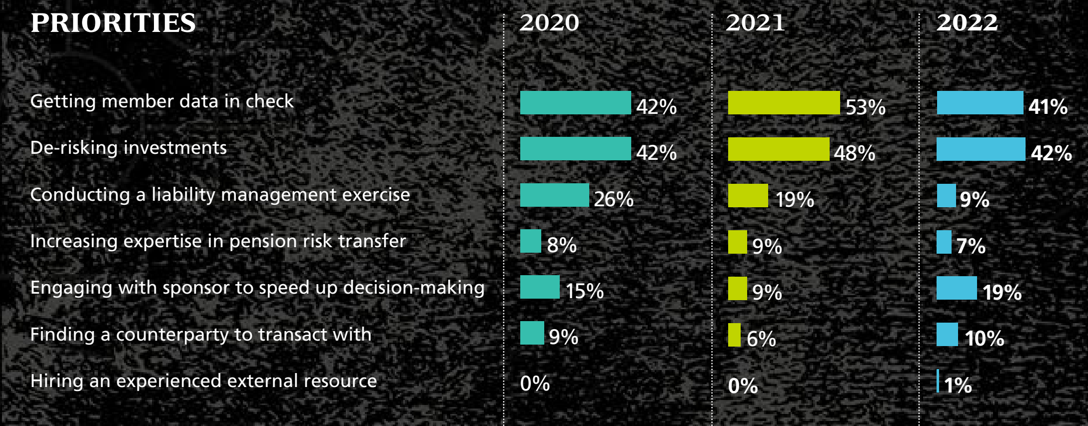
Like last year, schemes targeting buy-out are making steady progress towards their endgame – and 48% expect they are on pace to reach this target within the next five years.*



*Based on data collected in January and February 2022

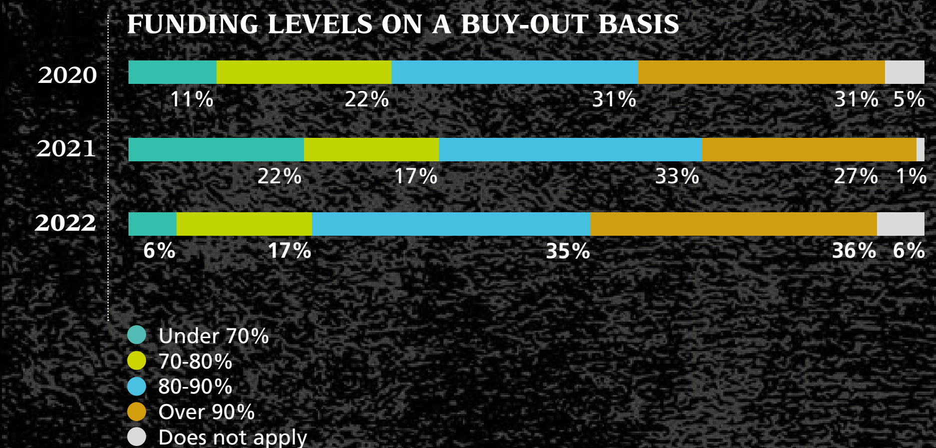
De-risking and data preparation are key priorities

Two out of every five pension funds are prioritising de-risking their investments and conducting data checks; however, some schemes are further behind with their endgame preparation. For example, 19% are focused on engaging with their sponsor to speed up decision making, which is double the figure from last year.



Underfunded schemes have improved their funding

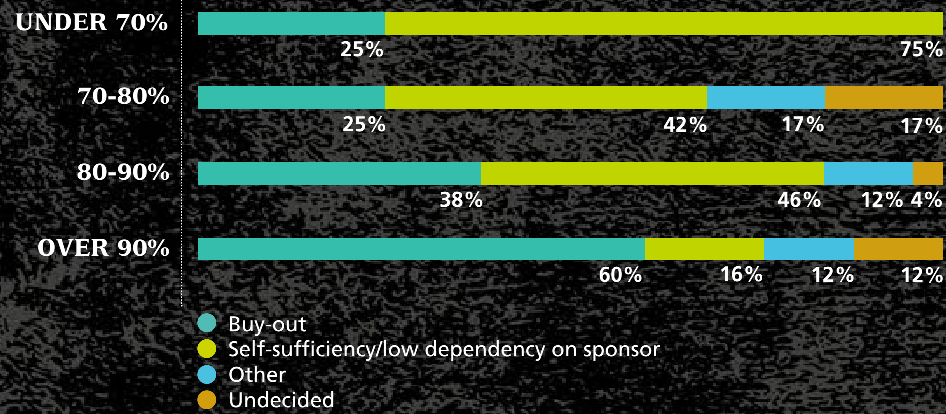
Buy-out funding has continued improving amongst well-funded schemes and those nearing their endgame. Interestingly, underfunded schemes are also better funded compared with last year. For example, just 6% of schemes are funded to a level below 70% – which is a sharp drop from last year when that figure was 22%.



Figures in the charts may add up to 99% or 101% due to rounding of percentages

Well-funded schemes continue to focus on buy-out

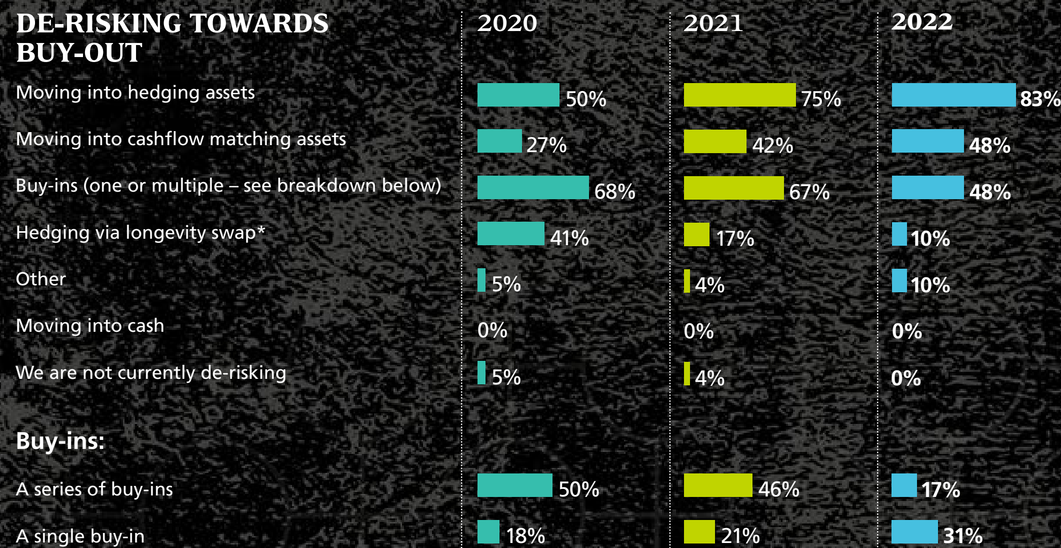
In our most recent survey, three out of five schemes funded on a solvency basis to a level above 90% state they are targeting buy-out – compared to just a quarter of schemes that are funded on a solvency basis below 70%. In contrast, underfunded schemes are far more inclined to choose self-sufficiency as their endgame.



Improved buy-out preparedness is making buy-ins less necessary

Nearly half of those working towards buy-out have completed one or multiple buy-ins as part of their de-risking – down from 67% last year. This may suggest that, although buy-ins are an important de-risking tool for those targeting buy-out, schemes see less need to conduct one if they are close to buy-out.

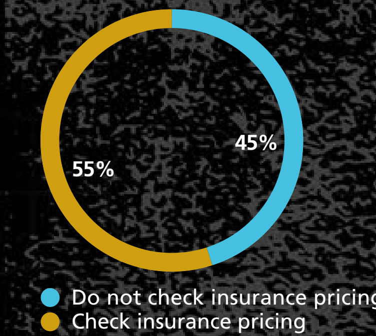
* In 2020, the answer option in relation to longevity swaps was phrased in a different way ("Hedging via a swap or similar"), which may have overlapped with "Moving into hedging assets" and similar answer choices. In 2021 we made this answer option clearer, although this means that the answers from 2020 are not directly comparable with results from more recent years.



Trustees are proactive about monitoring insurance pricing

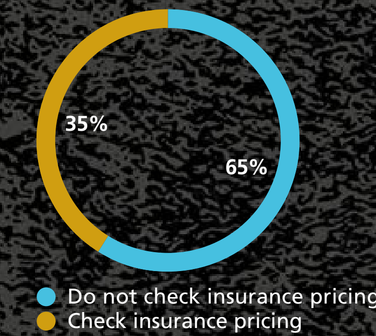
Over half of the schemes targeting buy-out regularly monitor insurance pricing – and 55% expect future pricing to remain about the same as it was at the start of the year.

AIMING FOR BUY-OUT



- Do not check insurance pricing
- Check insurance pricing

AIMING FOR SELF-SUFFICIENCY

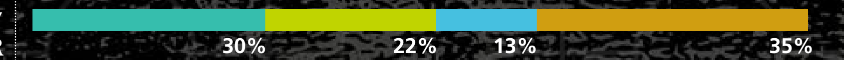


- Do not check insurance pricing
- Check insurance pricing

Interestingly, 30% of those pursuing low dependency are confident that future pricing will become cheaper, which may signal that some of these schemes may go for buy-out once pricing improves.

AIMING FOR BUY-OUT

AIMING FOR SELF-SUFFICIENCY/ LOW DEPENDENCY ON SPONSOR

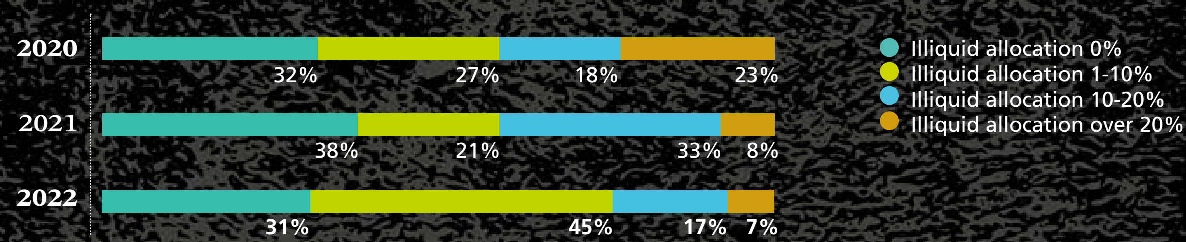


- Pricing to become cheaper
- Remain the same
- Become more expensive
- Don't know

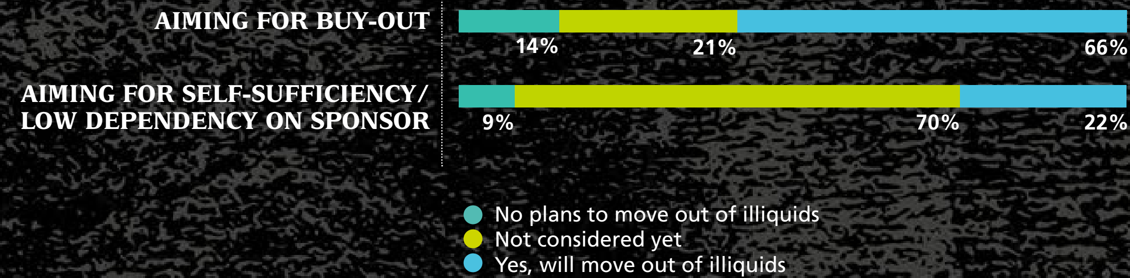
Figures in the charts may add up to 99% or 101% due to rounding of percentages

Schemes targeting buy-out plan to reduce their illiquid exposure

Schemes on the path towards buy-out are moving away from illiquid assets. In 2022 just 24% allocated over 10% to illiquids, which is a sharp drop from last year.



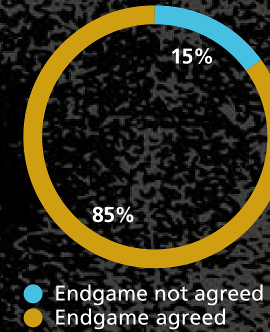
Additionally, two-thirds of those targeting buy-out intend to fully divest from such allocations. This demonstrates that many schemes on the path to buy-out do not expect insurance providers to take their illiquid allocations in-specie in a transaction.



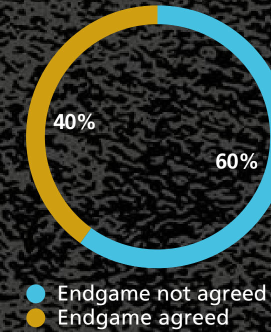
Endgames are more readily agreed when sponsors receive the surplus

The ability to release surplus to the sponsor makes sponsors more likely to have already agreed the scheme's endgame plans. For example, 85% of schemes where the surplus is set to go to the sponsor have agreed endgame plans.

SURPLUS GOES TO THE SPONSOR



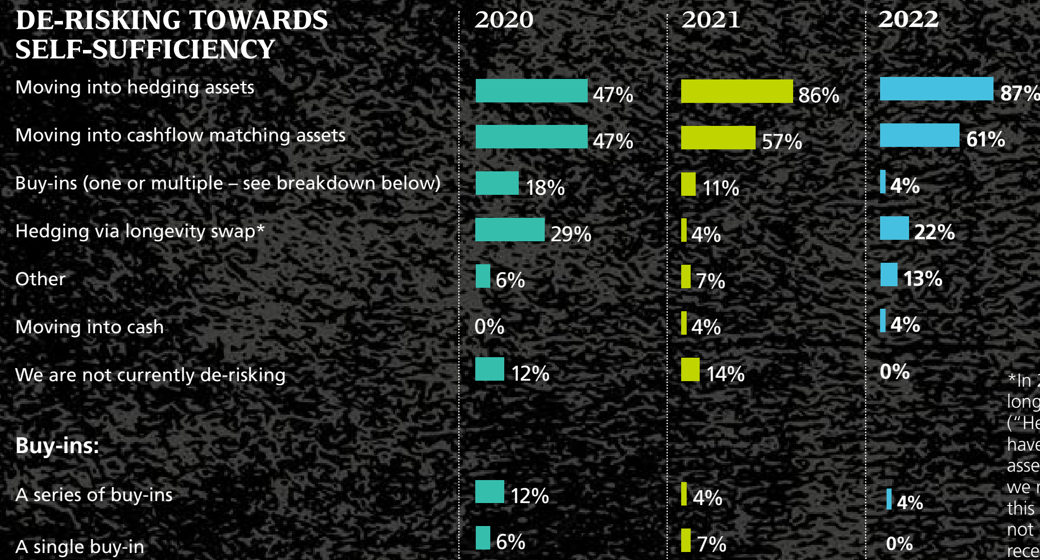
SURPLUS GOES TO THE MEMBERS



Figures in the charts may add up to 99% or 101% due to rounding of percentages

Longevity swaps have a role to play in self-sufficiency

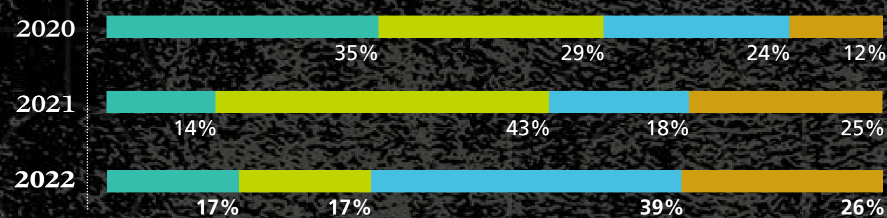
Schemes targeting self-sufficiency are less likely to use buy-ins than those on the path towards buy-out. Instead, most of these schemes will rely on hedging and cashflow matching assets. However, 22% have gone for a longevity swap* – up from 4% last year. This suggests that some of these schemes are starting to make use of insurance solutions as they mature and move closer to low dependency on the sponsor.



*In 2020, the answer option in relation to longevity swaps was phrased in a different way ("Hedging via a swap or similar"), which may have overlapped with "Moving into hedging assets" and similar answer choices. In 2021 we made this answer option clearer, although this means that the answers from 2020 are not directly comparable with results from more recent years.

Illiquid assets appeal to schemes aiming for low dependency

Schemes working towards self-sufficiency continue to grow their illiquid asset allocations. 17% of schemes surveyed lack an exposure to such assets, with nearly two-thirds allocating over 10% of their portfolio to illiquid assets – up from 43% last year. This shift towards illiquid assets likely reflects the greater need for returns and assets that can provide long-term reliable cashflows.

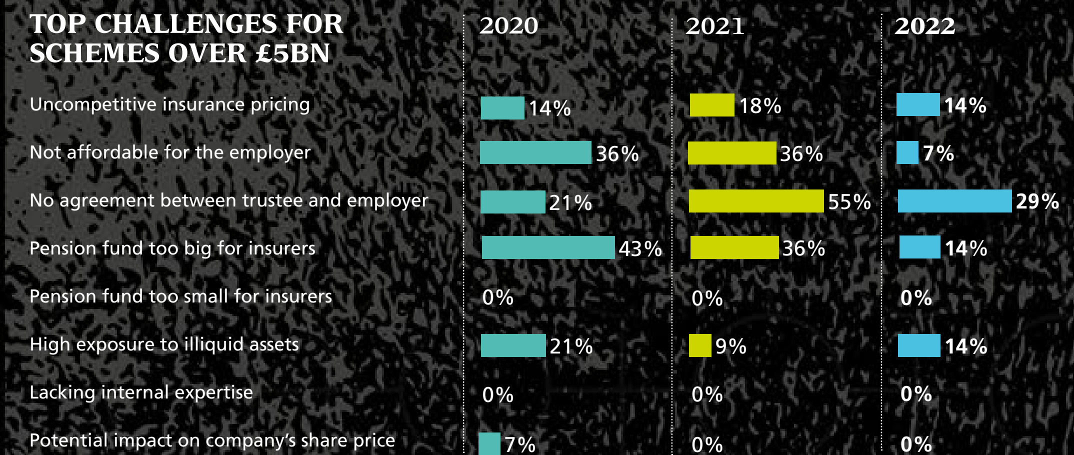


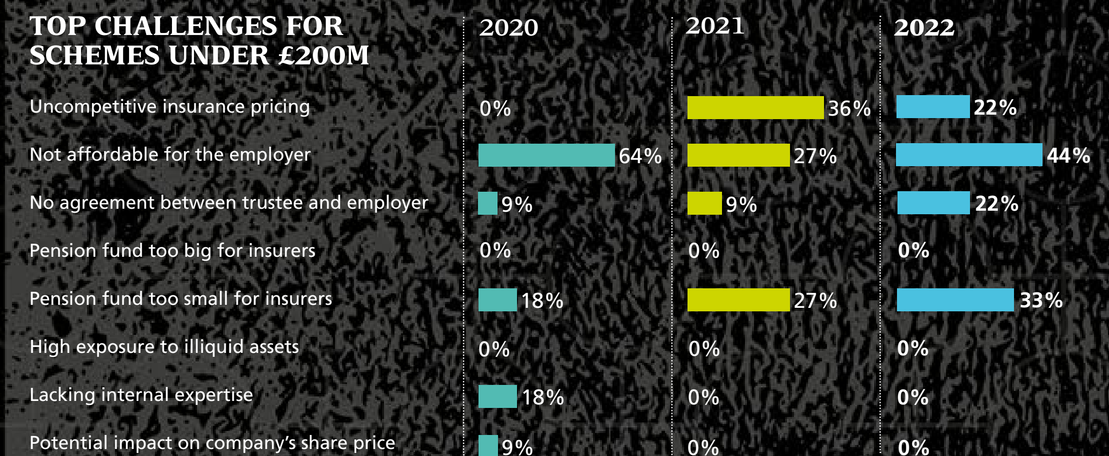
Illiquid allocation 0%
Illiquid allocation 1-10%
Illiquid allocation 10-20%
Illiquid allocation over 20%

Buy-out is not equally accessible for all

14% of schemes with assets over £5bn think they are too big to insure – down from 36% last year. This suggests that buy-out providers are better equipped to engage in larger transactions with such schemes.

However, buy-out may still be out of reach for many smaller schemes with assets below £200m. For example, 44% worry that this endgame is not affordable for their sponsor – up from 27% last year. Additionally, a third of such schemes are concerned that their pension fund may be too small to transact with an insurer.



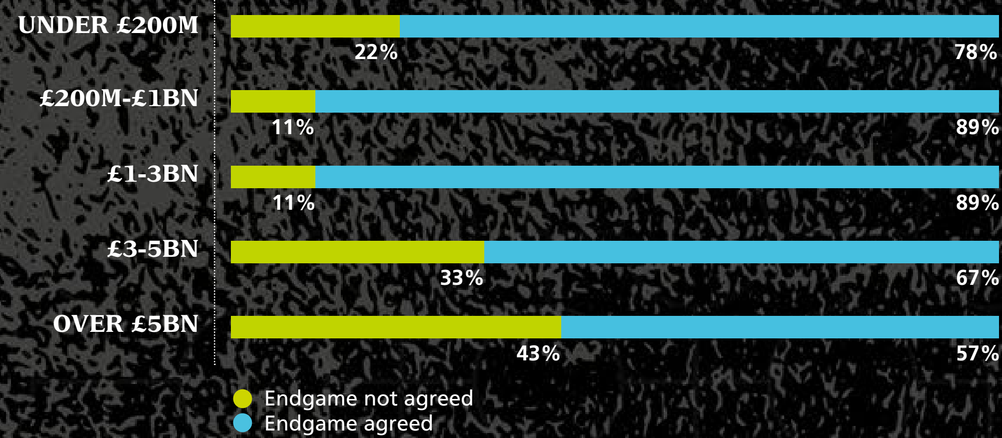


Figures in the charts may add up to 99% or 101% due to rounding of percentages

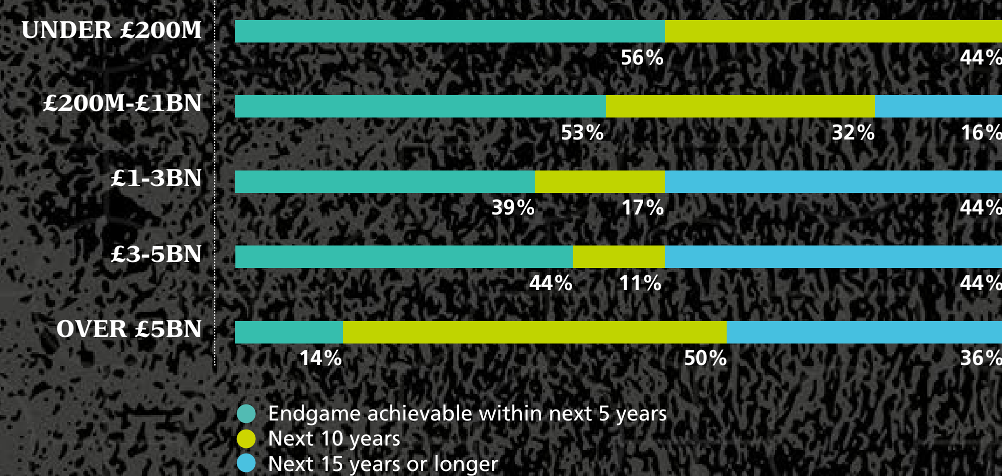
Many larger schemes are still working out their endgame plans with the sponsor

While most small and mid-sized schemes have already agreed endgame plans with their sponsor, 43% of large schemes over £5bn have yet to agree this. This may reflect that, although larger schemes are less worried that their size will prevent them from accessing the insurance market, many still need to convince their sponsor that this is a feasible endgame for their scheme.

ENDGAME AGREED?

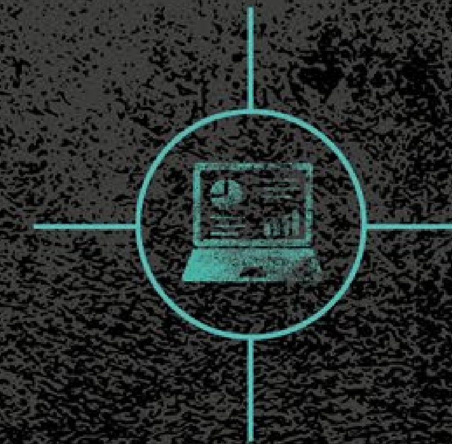


TIMEFRAME TO ENDGAME



There is minimal appetite for consolidation as an endgame

Although TPR has provided guidance on superfunds, consolidation is still not a popular endgame alternative. However, it may become necessary, in rare cases, where there is a sudden deterioration of the sponsor covenant, or for smaller schemes which are unable to transact with an insurer.

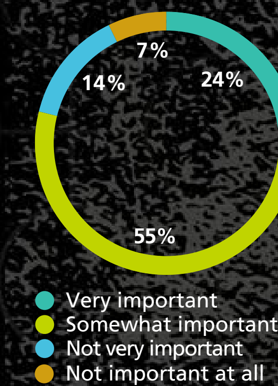


91% are not considering consolidation

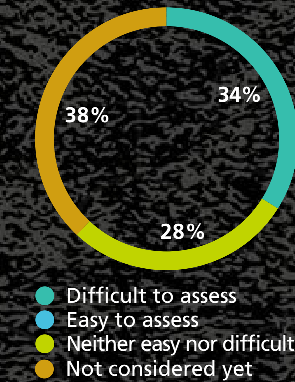
ESG will be a key factor during counterparty selection

Over half of the schemes pursuing buy-out consider ESG considerations to be "somewhat important" when choosing a transaction counterparty. However, 34% of such schemes have had a difficult time evaluating the ESG credentials of insurance firms. It is clearly important that insurance firms take steps to clearly communicate how ESG considerations will factor in a transaction.

ESG CONSIDERATIONS



ESG CREDENTIALS OF INSURANCE FIRMS



Figures in the charts may add up to 99% or 101% due to rounding of percentages

MALLOWSTREET SURVEY RESULTS

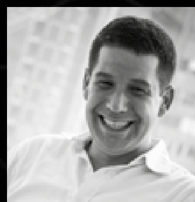
“mallowstreet’s mission is to empower every pension fund to make better decisions, meaning every person can have a better retirement.”

mallowstreet

The survey results in this publication are based on a survey of 69 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

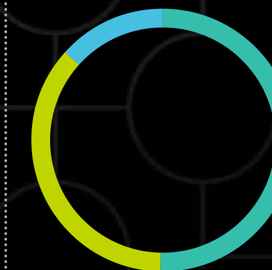
ALLY GEORGIEVA
Head of Insights

RYAN DALEY
Senior Investment Researcher

BY ASSET SIZE

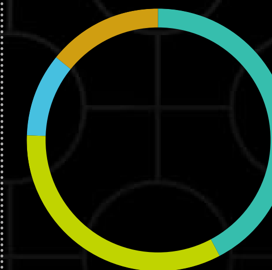
>£5bn	**20%** (14)
£3-5bn	**13%** (9)
£1-3bn	**26%** (18)
£200m-£1bn	**28%** (19)
<£200m	**13%** (9)

BY COVENANT STRENGTH



Strong	**50%** (35)
Tending to strong	**36%** (25)
Weaker	**13%** (9)

BY ENDGAME

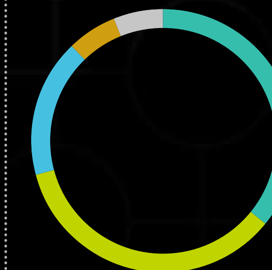


Buy-out	**42%** (29)
Self-sufficiency	**33%** (23)
Undecided	**10%** (7)
Other	**14%** (10)

BY BUY-OUT DISCOUNT RATE

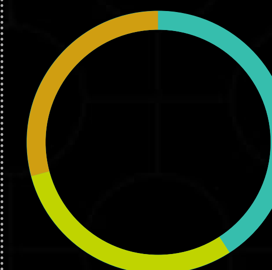
Gilts plus 1-50 bps	**14%** (10)
Gilts flat	**22%** (15)
Gilts plus 1-50 bps	**29%** (20)
Other	**9%** (6)
Unknown/Does not apply	**26%** (18)

BY FUNDING LEVEL ON BUY-OUT BASIS



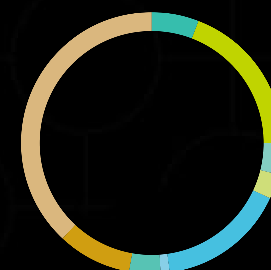
>90%	**36%** (25)
80-90%	**35%** (24)
70-80%	**17%** (12)
<70%	**6%** (4)
Does not apply	**6%** (4)

BY TIME TO ENDGAME



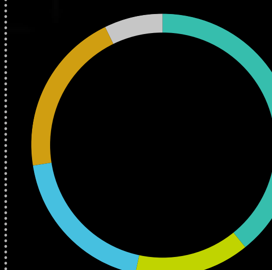
Next 5 years	**41%** (28)
Next 10 years	**30%** (21)
Next 15 years or longer	**29%** (20)

BY SPONSOR SECTOR



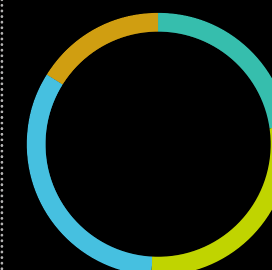
Construction	**6%** (4)
Finance/Banking	**19%** (13)
Healthcare	**4%** (3)
Information Technology	**3%** (2)
Manufacturing	**16%** (11)
Oil and Gas	**1%** (1)
Transport and Logistics	**4%** (3)
Wholesale Retail	**9%** (6)
Other	**38%** (26)

BY SCHEME SURPLUS RECIPIENT



The sponsor	**39%** (27)
The members	**14%** (10)
Other	**19%** (13)
I don’t know	**20%** (14)
Yet to be discussed	**7%** (5)

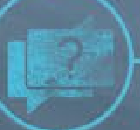
BY POWER TO WIND UP THE SCHEME



The sponsor	**23%** (16)
The trustee	**28%** (19)
Jointly agreed	**33%** (23)
I don’t know	**16%** (11)

J2
B3

2022 jargon buster



J2B3

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 in 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***.
Benefits mismatch	This is where the benefits insured by the insurer do not exactly match those provided under the scheme.
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 (e.g. in relation to pensions payable where there is financial dependency) and may look to codify these.
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 and commonly used to describe the status of a buy-in once the data cleanse and premium adjustment have been completed.
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.

Term	Explanation
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***.
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 a 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 consolidator will hold 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 (e.g. 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.
Deed poll	A declaration and undertaking by the insurer that, in accordance with the terms of the ***buy-in***, the insurer assumes the obligation to pay benefits directly to scheme members. This is used to allow the insurer to assume the obligation to pay the benefits directly to scheme members before issuing ***individual policies*** and ***buy-out*** occurs at that point rather than when ***individual policies*** are later issued.
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.
ESG	ESG covers environmental, social and governance issues (but consensus on details of the meaning can vary).
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***.

jargon buster

Term	Explanation
Experience data	The data the trustee holds about the exits (including deaths and transfers) from 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.
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 (e.g. 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 policies	Insurance policies issued by the insurer in the name of scheme members, these are issued at the point of ***buy-out***.
Individual surrenders (e.g. 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 (e.g. names, National Insurance 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 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.

jargon buster

Term	Explanation
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 scheme's members to get details of members' marital status. This can be useful for insurers and reinsurers when pricing a transaction.
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***.

jargon buster

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 (e.g. 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.

jargon buster

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.
Transaction schedule	A schedule to an ***umbrella contract/umbrella bulk annuity policy*** which sets out the terms specific to that ***buy-in*** transaction.
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***.
Umbrella contract/Umbrella bulk annuity policy	A pre-agreed set of terms for a ***bulk annuity*** policy that can be used for a number of ***bulk annuity*** policies between the same trustee and insurer. Transaction specific terms will be included in a ***transaction schedule***.
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.
Wrap-around cover	This is a type of residual risk cover, which applies where one insurer provides residual risk cover in respect of scheme liabilities that are already covered by a buy-in with another insurer (i.e. the residual risk cover "wraps around" the existing buy-in). It often applies from buy-out, with the final buy-out insurer providing residual risk cover in respect of all scheme members, including those whose core benefits are already covered by a previous buy-in with another insurer.

SARAH PARKIN
Linklaters

Sarah is a Partner in Linklaters' pensions team and has specialised in pensions law for over 14 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 2021 on "Legal implications of longevity risk".

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); Marks and Spencer Pension Scheme (six transactions with three insurers totalling c.£3.5bn of liabilities); Aviva Staff Pension Scheme (two transactions with Aviva Life totalling c.£2.5bn of liabilities); and 3i Group Pension Plan (£650m buy-in with L&G); and Co-operative Pension Scheme (four transactions with two insurers totalling c.£2.76bn of liabilities).

CONTACT US

SAMMY COOPER-SMITH
Head of Business Development

sammy.cooper-smith@rothesay.com
Direct dial: +44 (0)20 7770 5426
Mobile: +44 (0)7725 278 873

TOM SEECHARAN

tom.seecharan@rothesay.com
Direct dial: +44 (0)20 7770 5427
Mobile: +44 (0)7813 119 958

CLEO TAYLOR SMITH

cleo.taylorsmith@rothesay.com
Direct dial: +44 (0)20 7770 5322

KATIE OVERTON

katie.overton@rothesay.com
Direct dial: +44 (0)20 7550 0688
Mobile: +44 (0)7765 405 726

RÓISÍN O'SHEA

roisin.o'shea@rothesay.com
Direct dial: +44 (0)20 7550 0610
Mobile: +44 (0)7709 767 617

RACHEL BRADSHAW

rachel.bradshaw@rothesay.com
Direct dial: +44 (0)20 7550 0758
Mobile: +44 (0)7568 504 119

STEPHEN LONGFELLOW

stephen.longfellow@rothesay.com
Direct dial: +44 (0)20 7550 0653

THE JOURNEY TO BUY-OUT 2022

WE HOPE YOU HAVE ENJOYED GETTING THERE

FOREST CARBON

In recognition of the carbon impact of this publication we are investing in Woodland Carbon Code certified woodland creation in the UK that will not only capture our CO2 over time, but will also offer a host of other benefits, including flood alleviation, water quality improvements, habitat creation, employment, public access, sustainable timber and cleaner air. We are mitigating our activities, helping the UK landscape and economy adapt to a new climate, and helping the country meet its Net Zero ambitions.

Designed and produced by emperor
Visit us at emperor.works

Rothesay
The Post Building
100 Museum Street
London
WC1A 1PB

Rothesay