

De-risking transactions – Overview and Legal Issues



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Most Innovative Firm in Corporate Law –
Longevity Deals for Pension Funds and
Pension Solution Providers
Financial Times Innovative Lawyers Awards
2012



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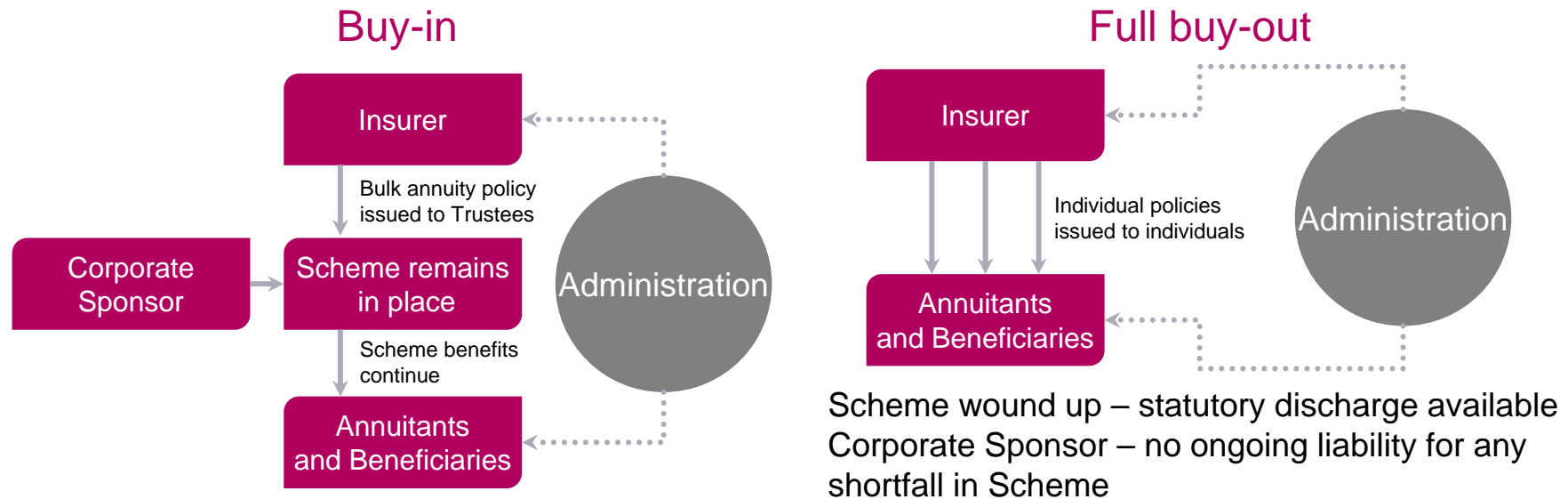


Development of the market

- > Traditional **buy-ins** and **buy-outs** (eg Legal and General's buy-ins of Dairy Crest; Aon Minet; Sears and the IMI pension scheme)
- > **Annuity reinsurance** and sales potentially with a FSMA Part VII transfer (eg Save & Prosper's acquisition of annuities from Prudential)
- > **Longevity derivatives with insurers** (eg JP Morgan's derivative provided to Canada Life)
- > **Longevity reinsurance**
- > **Longevity derivatives with pension schemes** (eg Credit Suisse)
- > **Longevity insurance with pension schemes** (current UK providers include Legal & General)
- > More developments in the **buy-in** and **buy-out** (ranging from enhanced medical underwriting on the one hand to, broadly speaking an "all-risks" model on the other hand, including the Uniq buy-out by Rothesay Life)
- > **Longevity "disintermediation"** (Aviva being the first deal to "cut out the middleman")
- > **Use of offshore cells for longevity solutions** – incorporated cell companies/protected cell companies

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The Products: Buy-ins/outs

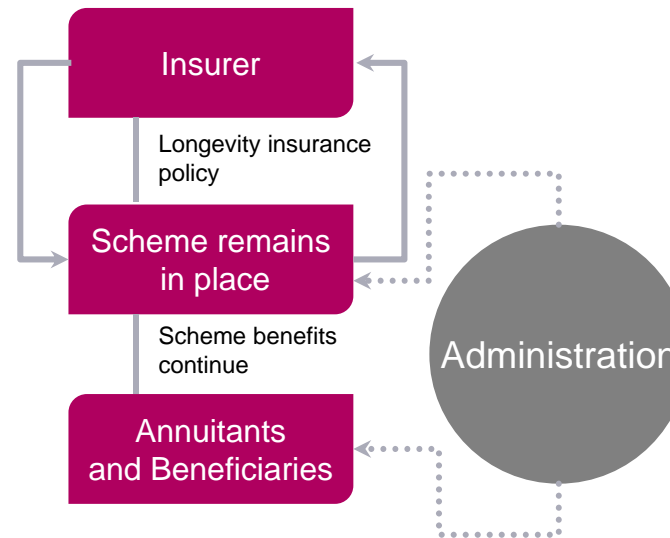


- > These are the more traditional insurance products available to trustees
- > Insurance product issued by insurers – constitutes an asset of the scheme
- > Longevity risk, inflation, investment risk and second life risk is transferred
- > Premium typically paid up front and generally calculated as the present value of future benefits calculated applying insurer's pricing basis and actuarial assumptions to scheme data
- > In a buy-in, benefits are usually carefully defined by insurers (to avoid non-disclosed/discretionary benefits being included) although some are "all risks" (and include data risk)
- > Shorter term with no termination rights

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The products: longevity “insurance”

Periodic premium payments reflecting the projected payments expected to be made by the scheme plus a fee

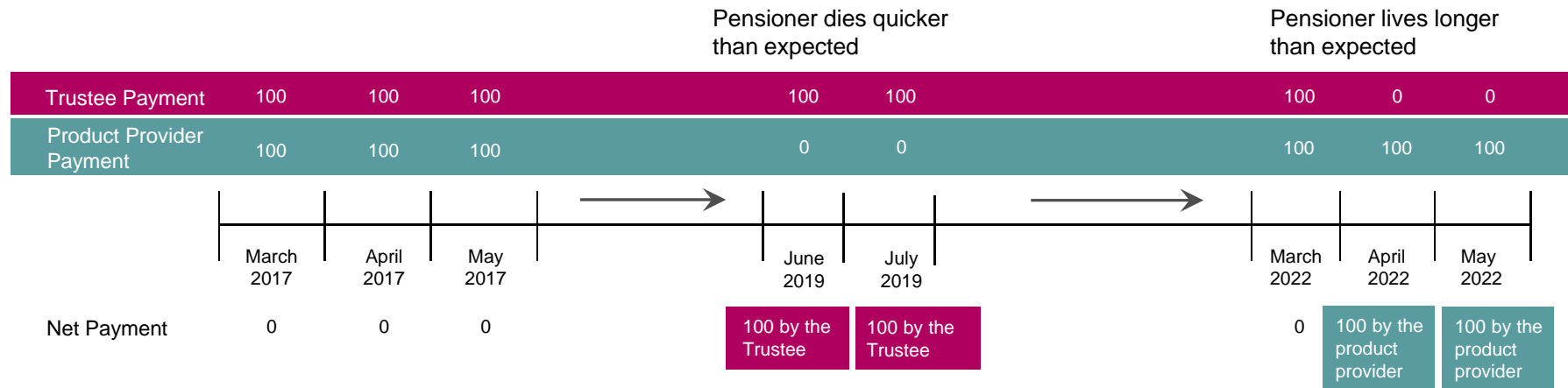


Periodic claim payments reflecting the actual payments made by the scheme

- > Insurance product issued by insurers – constitutes an asset of the scheme
- > Longevity risk (and potentially second life risk) is transferred
- > Benefits and beneficiaries are usually carefully defined by insurers (to avoid non-disclosed/discretionary benefits being included)
- > Long term with many termination rights

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Longevity: basic cash flows



- > Premiums typically generally calculated at the present value of future benefits calculated by applying the insurer's pricing basis and actuarial assumptions to scheme data but paid over the course of the transaction
- > Claim payments are essentially equal to the actual "in scope" annuity payments to beneficiaries.
- > Expected payments are swapped with actual payments
- > The pensioner is 60 years old and is modelled to die in March 2022 (using an agreed model and carefully defined benefits). He has an annuity of £100 per month
- > The trustees will pay £100 per month to the insurer until March 2022
- > While the pensioner is alive, the insurer will pay £100 per month to the trustees. These sums will net out so no payment will be made
- > If the pensioner dies in June 2019, the insurer will no longer pay amounts after his death but the trustees will still be obliged to pay to the insurer the £100 per month until March 2022, resulting in a payment by the trustees of £100 a month
- > If the pensioner dies after March 2022, the trustees' obligation to pay ceases, but the insurer's obligation to pay continues until death, resulting in a payment by the insurer of £100 a month
- > This ignores the fee.

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Buy-in vs Longevity insurance

Insurer perspective

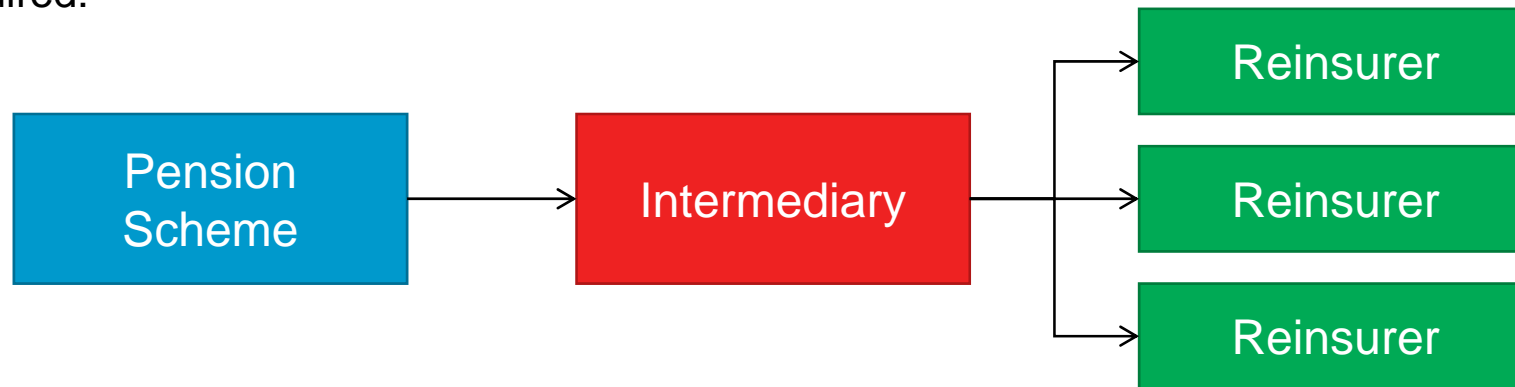
- > Risk appetite
- > Available assets
- > Market conditions
- > Reinsurance availability
- > Cost of execution

Scheme perspective

- > Risk appetite
- > Available assets
- > Market conditions
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Longevity insurance structures

- > Ultimate longevity risk takers are global reinsurers who use it to offset mortality risks
- > UK Pension Scheme cannot directly contract with a reinsurer – an intermediary is therefore required:



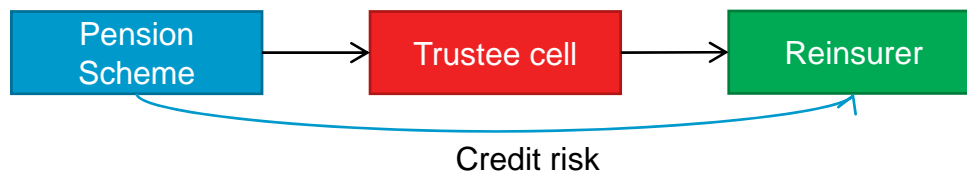
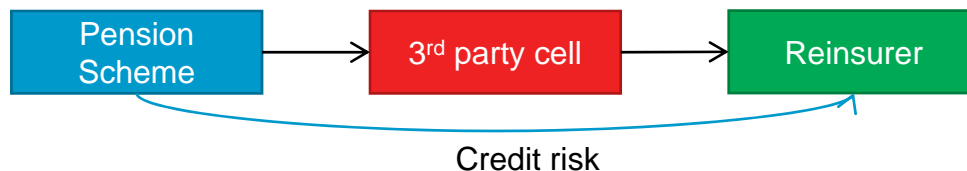
- > Intermediary has traditionally been a UK insurer or bank
- > Intermediary:
 - > Accepts reinsurance credit risk (risk of reinsurer default)
 - > May or may not retain some longevity risk
 - > Carries out administration and related functions

Current intermediation structures

> Traditional – fully intermediated

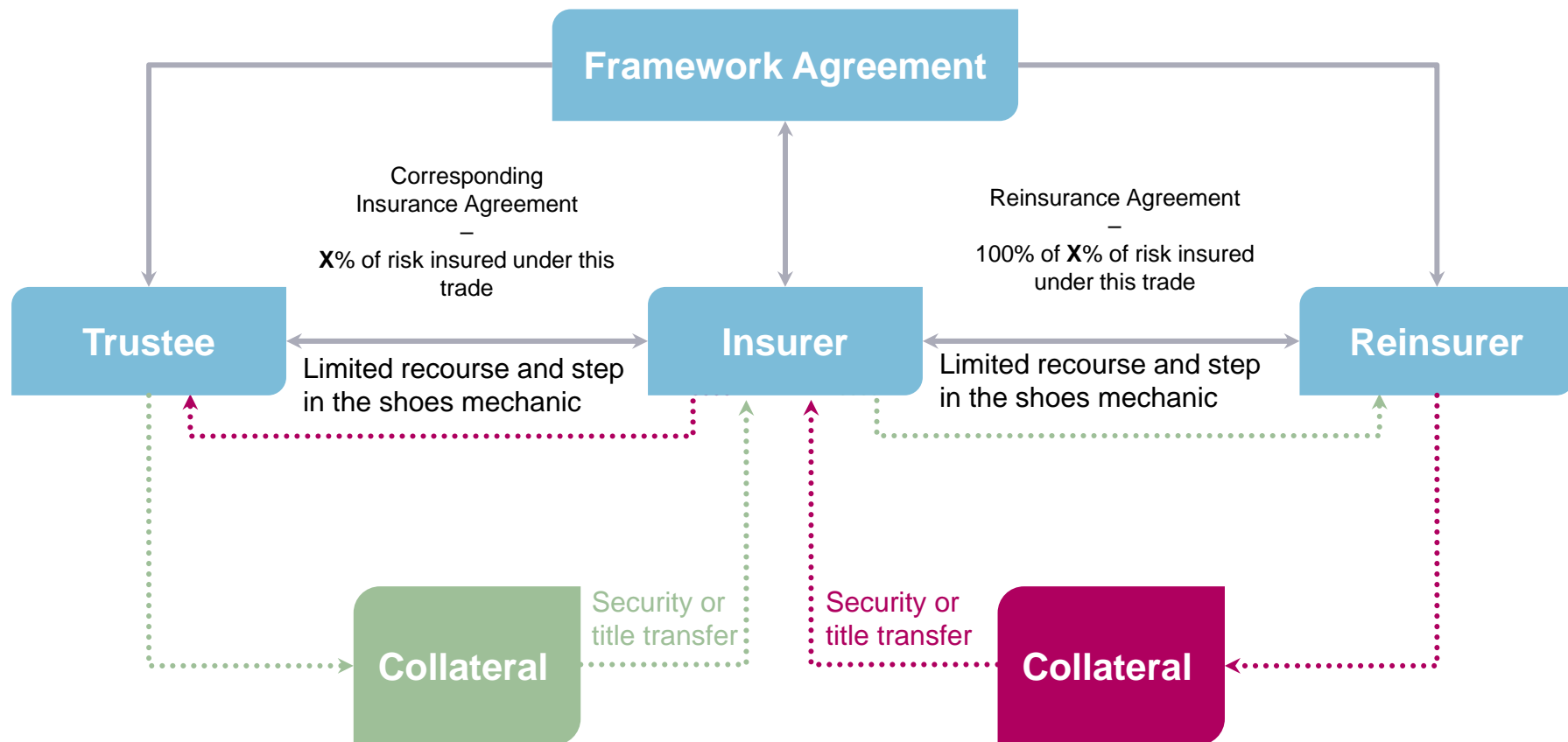


> “Pass-through”



Risk/responsibility transferred	UK Insurer	3 rd Party	Trustee vehicle
Longevity	✓	✓	✓
Admin	✓	✓	✗
Regulatory	✓	✓/✗	✗
Legal	✓	✓/✗	✗

Example of a longevity disintermediated structure



Market developments

- > Solvency II has had a material impact on insurers' reinsurance strategies
- > "Risk Margin" onerous for retained longevity risk
- > Almost all of the major buy-in/out providers are now reinsuring significant amounts of new business
- > Reinsurance credit lines have therefore become more valuable
- > Desire to write traditional longevity intermediation business for larger schemes has declined. Schemes have also recognised value savings in pass-through structures
- > Simplified structures for smaller schemes (fully intermediated) becoming more prevalent:
 - > Simplified reporting
 - > Simplified benefits
 - > Simplified (or no) security structures

Structures – making the decision

- > Is the structure available?
 - > Rapidly moving market place
- > What are the costs?
- > What are the risks?
 - > Credit risk
 - > Legal/regulatory risks
 - > Cost certainty
 - > Reputational risks

Longevity commercial positions

- > Termination rights
- > Collateral
- > Data Errors: type, re-pricing thresholds, remedy, transparency
- > Back to back protections:
- > Discretionary benefits
- > Removing individuals from the transaction
- > The move from longevity to bulk annuity



Trustee issues



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Is there power to do the transaction?

What rule applies?

- > Transfer rule?
- > Investment power?
- > Specific buy-in power?
- > Winding-up rule?
- > Is the rule broad enough? Is there sufficient flexibility?

Think about a rule amendment if there is any doubt

Steps in a bulk annuity transaction

- > Identify potential insurers, send initial data and details of any key terms required, obtain quotations;
- > Meet with insurers;
- > Agree exclusivity with a preferred insurer;
- > Negotiate legal terms;
- > Execution;
- > Insurer goes on risk, assets/cash paid over to insurer;
- > Data cleansing;
- > True up payment;
- > Move to buyout (if appropriate).

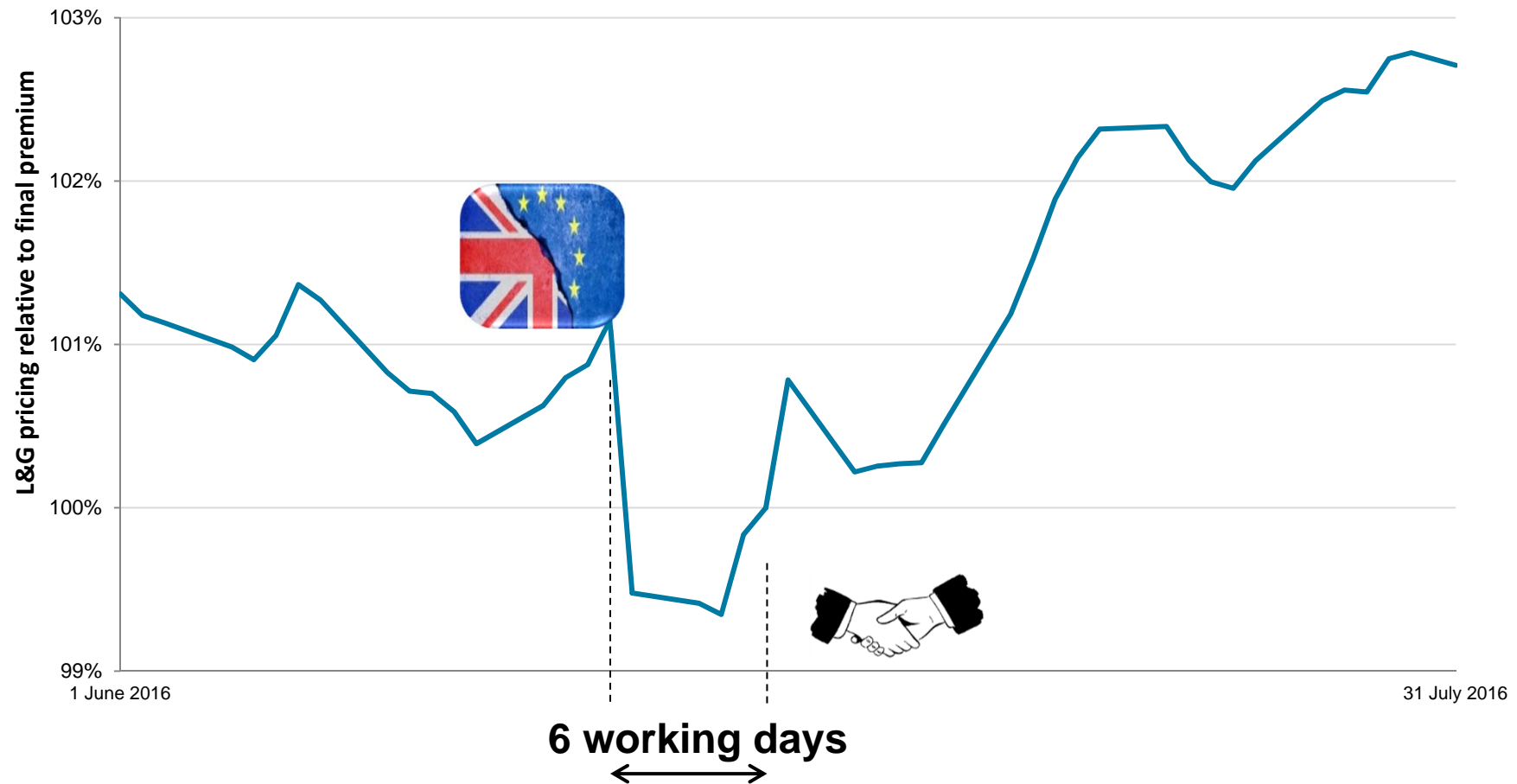
Getting data ready

Most schemes are in process of reviewing data held in light of tPR
Guidance

- > Consider which missing elements would impact on a longevity deal
- > Review priorities?

Better data = more accurate quotes = quicker deals (and better price?)

Clean data and transacting quickly



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Protecting data

Trustees will need to transfer data to obtain quotes

- > Insurers/providers will need to transfer data to re-insurers

Trustees need to ensure compliance with data protection legislation

- > Fair processing notice: requires notification to members of purpose for which data is used
- > NDAs: purpose of data transfer; restrictions on use; confidentiality; timing
- > Restrict data transfer to what is needed

Adopt a practical approach

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Analyse the benefits

Trustees need to understand what benefits will be “covered”

- > all risks vs defined risks

Identify:

- > what benefits are outside Rules?
- > scope of discretions and proposals to manage these
- > other benefit issues eg equalisation; underpins

Clarify benefit structure where appropriate

Understand:

- > interaction with Scheme discretions in an ongoing scheme (longevity transaction/buy-in)
- > powers to vary the insured benefits (buy-out)

Early analysis can save time when transacting

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Understand the legal document

Trustee “knowledge and understanding” requirements include a requirement to understand key contracts

The exclusivity agreement: understand who is locked into what!

The formal contract:

- legal structure
- risks transferred and risks retained
- termination events
- pricing/uncertainties/ability for provider to re-price
- the practical process

Consider requesting “key terms” at outset – don’t assume terms are standard

Understand what is needed from the Trustee and others

Training: Does the Trustee Board understand the proposed deal structure, risks and benefits?

Decision making: scope and timing of decisions required

Input needed from Scheme administrator: data
benefits
communications

Investment issues: timing and practicalities of any disinvestment

A project plan and buy-in from all stakeholders is key

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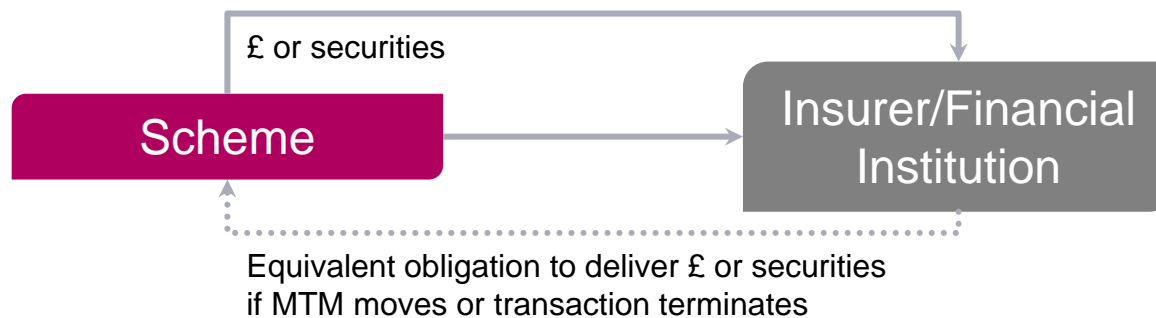
Collateral



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Collateral/Security – the structures

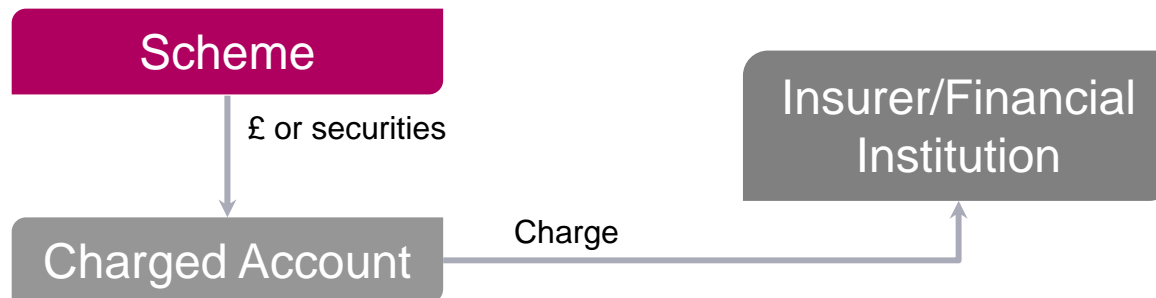
Outright transfer (single leg for illustration)



Pros: Recipient's right to use collateral for exits/unlikely to trip negative pledge/enforcement action not required

Cons: Overcollateralisation exposure for provider

Security interest



Pros: Transferor retains proprietary interest in charged assets

Cons: Funding cost for collateralising exits/may trip negative pledge/enforcement action required/possible formalities

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Collateral/Security

Types of collateral asset

- > typically cash and gilts (subject to pre-determined haircuts)

Alternatives?

- > parental guarantees (depending on the financial strength of the guarantor)
- > letters of credit

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Collateral/Security

- > **Amount**
 - > typically the expected claim amount (ie difference between future premium/expected claims or future fixed payments/expected floating payments).
 - > fees may also be collateralised (security interest to avoid O/C exposure)
- > **Minimum Transfer Amounts** – hurdles before collateral is required to be posted
- > **Frequency** – more frequent valuations limit O/C exposure but increase administrative burden
- > **Administration of arrangements** – trustee will likely need assistance in managing obligations
- > **Termination** – value of outright transferred collateral is set off against termination amount. Mismatch where the termination amount is not calculated using the same basis or on the same date as the latest collateral valuation

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Any Questions?



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