Rothesay
Protecting Pensions

THE JOURNEY TO BUY-OUT 2024

WELCOME TO THE ENDGAME

INTRODUCTION

THIS IS OUR FOURTH PUBLICATION FOCUSED ON THE "JOURNEY TO BUY-OUT"

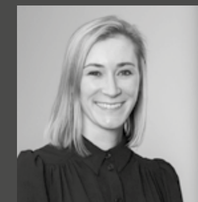
WELCOME TO THE ENDGAME

We took a break last year as we wanted to ensure each publication was a meaningful addition to what went before. We are delighted to return with our fourth edition.

With pension scheme funding reaching record levels, 2023 saw the bulk annuity market write record volumes of nearly £50bn over a record number of transactions. Whilst the market wrote 226 transactions, only a small number (12) were over £1bn. Although these larger transactions grabbed the headlines, they are only a small proportion of the schemes that secured their liabilities with an insurer last year. In fact the median transaction size was more like £40m and this publication attempts to show that there is a thriving market for schemes of all shapes and sizes.

This year we have collated a series of articles that look at some current topics of focus. We discuss how the marketplace is changing as well as the emergence of new bulk annuity providers and the potential of a public sector consolidator. We have taken a look through the lens of an administrator and what a buy-out process may mean for them. A few of the authors have considered whether price is the most important factor or whether there are other considerations that can have an impact on which insurer is selected. We discuss illiquid assets, funded reinsurance and demand for longevity swaps as well as taking a deep dive into Solvency UK.

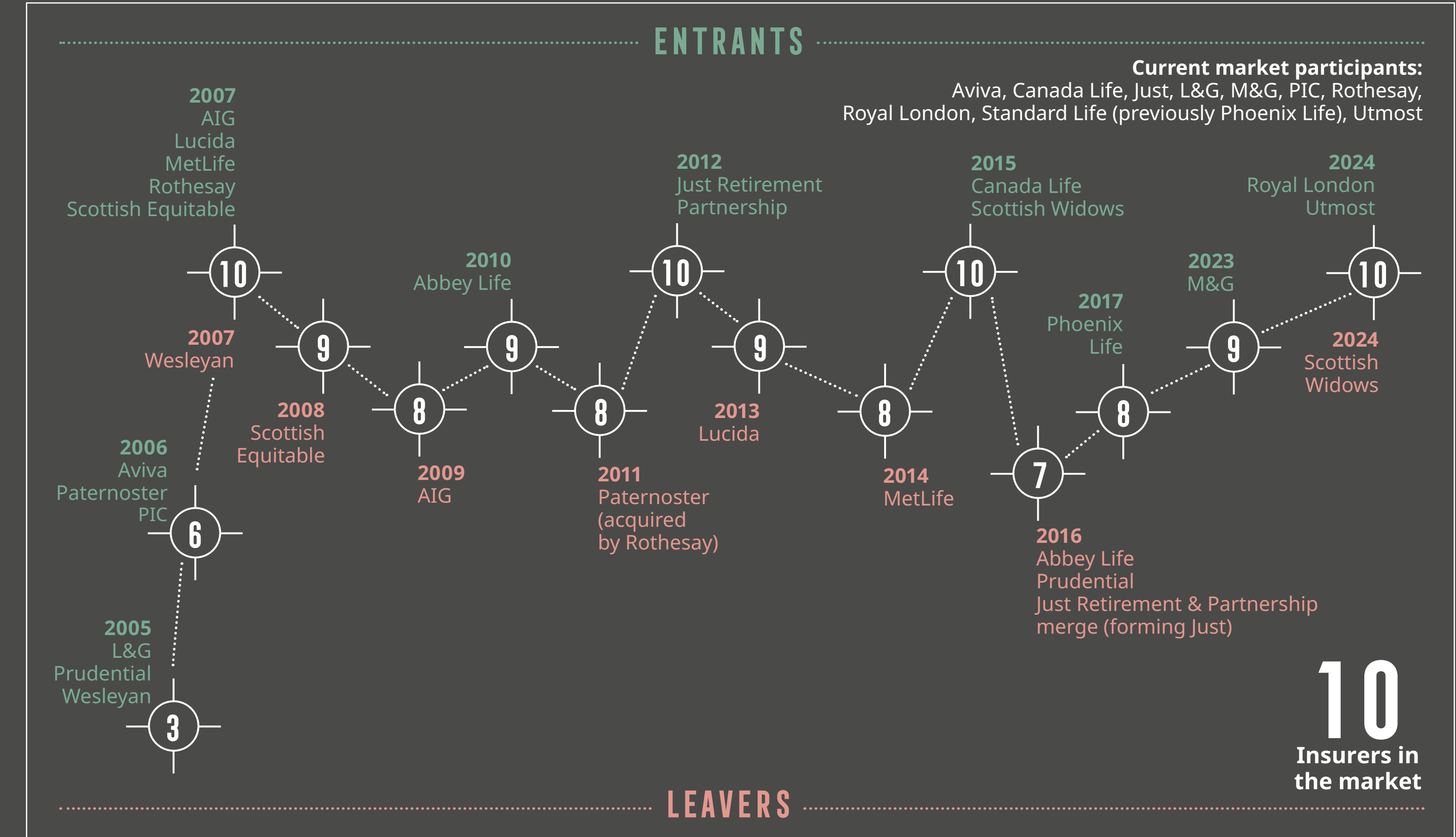
We hope we have captured topics that are of interest to you and provide you with some helpful insight as you navigate your own scheme's endgame plan.



Katie Overton

Róisín O'Shea

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
RSA	6,500	PIC	Feb 2023	Buy-in
Boots	4,800	L&G	Nov 2023	Buy-in
GEC 1972 Plan (telent)	4,700	Rothesay	Sep 2019	Full buy-out
Rolls-Royce	4,600	L&G	Jun 2019	Pensioner buy-out
British Airways	4,400	L&G	Sep 2018	Pensioner buy-in
Co-op	4,000	Rothesay	Nov 2023	Buy-in
Allied Domecq (Pernod Ricard)	3,800	Rothesay	Sep 2019	Buy-in
Asda	3,800	Rothesay	Oct 2019	Full buy-out
British American Tobacco	3,400	PIC	Aug 2019	Buy-in
IBM	3,000	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
Thales UK	2,700	Rothesay	Dec 2023	Buy-in
British Steel	2,600	L&G	May 2023	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
British Steel	2,300	L&G	Jun 2022	Pensioner buy-in
Metal Box	2,200	PIC	Oct 2021	Full buy-out
British Steel	2,100	L&G	Dec 2022	Buy-in

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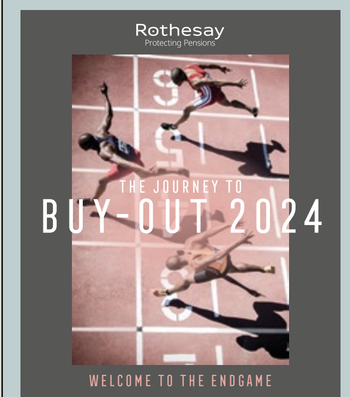

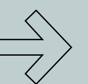

Chapter 1

A changing marketplace

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A change in the status quo – how the marketplace is changing

Will demand outweigh supply?

2023 was a record-breaking year in many respects. Not only did total business volumes exceed the previous high of £44bn in 2019, but 2023 also saw the largest ever deal, and the largest ever single bulk annuity transaction.

Behind the headlines however, there is a lot to digest in terms of how the marketplace is changing and evolving, and how schemes may need to adapt their strategies for approaching insurers to get the best possible outcome for their members.

The records from 2023 are largely explained by funding levels improving for a large number of schemes. For Aon clients, the average solvency funding level improvement over the course of 2021 and 2022 was in excess of 10%. As a result, significantly more schemes were, and still are, within touching distance of buy-out. Demand skyrocketed for insurance solutions, with trustees and sponsors looking to reach their endgame. This increase in demand is only expected to continue, generating higher deal volumes for insurers, but what does this mean for schemes preparing for their approach to the market and seeking to get the best deal?

Charlotte Quarmby
Aon

Charlotte is a Partner in Aon's Risk Settlement Group and Chair of the Institute and Faculty of Actuaries Bulk Annuity and Longevity Swap Member Interest Group. Over the last 10 years she has advised on around £30bn of buy-in transactions, including the recent transactions for Co-op (£4bn) and Co-op Bank (£1.2bn).

A change in the status quo – how the market-place is changing

Is the market still competitive?

The market is becoming segmented. With 'jumbo' deals being increasingly common, schemes and insurers involved at this end of the market are dealing with rising complexity to make these deals a reality. This in turn has a knock-on effect on the wider market, since increasing deal size and complexity means greater resource is needed, leaving less resource in an already constrained market for other schemes – particularly those at the smaller end of the market.

With insurers keen to make the most of their constrained resource, while also maximising deal certainty, some now require exclusivity in order to provide a quote for smaller schemes. We have seen insurers insist on sole-insurer processes for schemes with liabilities under £50m – and with the high levels of demand we are currently seeing, this may increase over 2024.

To trustees, working exclusively with one insurer might feel like placing all of your bets on one horse – and without knowing how many horses are in the race. However, schemes which achieve the best results in these scenarios are those advised by the most experienced risk settlement consultants. They have processes in place to scrutinise the single quotation and to robustly negotiate with the insurer to ensure the price paid is at fair market value, reflective of the whole market and in line with pricing from traditional, multi-insurer processes.

Innovation driving evolution

At the large end, the greatest focus is on the need to find solutions for the many schemes coming to market with complex assets. Following the significant increase in gilt yields over 2022, and many schemes finding themselves closer to buy-out earlier than originally planned, a new hurdle emerged for those with illiquid assets. With this asset class holding its value better than others, illiquids suddenly represented a larger proportion than intended of some schemes' portfolios and became an unexpected barrier to buy-out.

As with any well-functioning market, the insurers rallied around to create an array of solutions to solve the problem, including accepting these assets as part of the premium payment (for an agreed reduction in value) or offering a deferred premium, as well as some more complex and bespoke solutions.

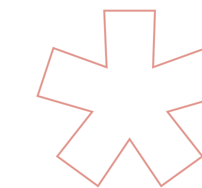
Despite the high level of activity in the market, insurers have - and continue to - invest time in developing innovative solutions for schemes in order to help ensure that their journey to buy-out is as smooth as possible. Whilst these innovations are initially created for the largest schemes, they trickle down into the mid-market and then the smaller end of the market. We expect this trend to continue, with large schemes paving the way for better solutions for all, even in a resource constrained market.

Maintaining a competitive market

For some schemes, it may feel like the market is shrinking – where mid-sized or larger schemes could have expected quotes from all active insurers in the market in years gone by, this might now realistically be a handful at best. This of course leads to less competitive tension in the broking phase, but with experienced advisers having more exposure to a greater number of deals, this is compensated for by a deep understanding and monitoring of overall market pricing. This can ultimately still deliver excellent outcomes for all stakeholders.

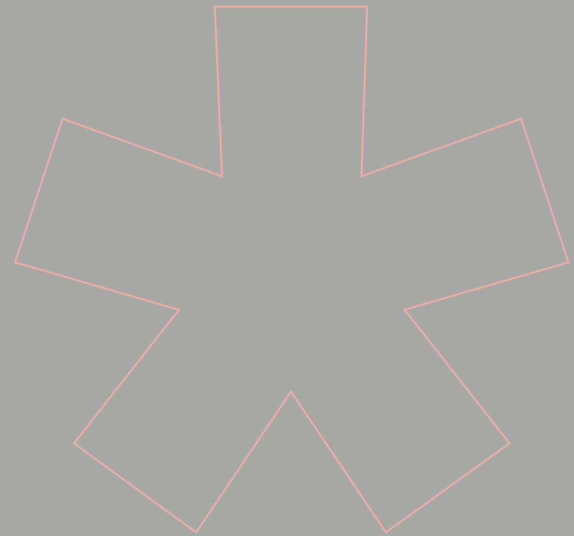
In reality, the market is growing, with the much-welcomed addition of a ninth insurer, M&G, in 2023, and its delivery of two deals in quick succession. This provides food for thought for the other insurers in the market, who are likely to want to ensure they remain competitive with another, hungry for new business, insurer in the mix. This should allow schemes to continue to access attractive outcomes for their members.

Although the barriers are considerable for new entrants to the market, demand for bulk annuities is also at an all-time high, so it seems likely that more insurers will join the race in the next few years. Even so, with all the current insurers committed to creating great solutions for schemes, and resulting in increasing volumes, we also expect their headcounts to grow. This will enable them to deliver both the deals and the security that both trustees and members are seeking.



What a time to be in the risk settlement market!

Funding level ready



– but what else is needed for a successful buy-out?

DB pension schemes in the UK have had their fair share of challenges in recent years, from longevity risk to regulatory changes and market volatility. Interest rates are now much higher than they were two years ago and many pension schemes were under-hedged against insurer pricing – meaning they have benefitted from improved funding levels which, on paper at least, suggest that a bulk annuity purchase, leading to a buy-out, is now an affordable option. Whilst buy-out affordability is an important factor, it is crucial for trustees to assess their readiness to actually complete this type of project.

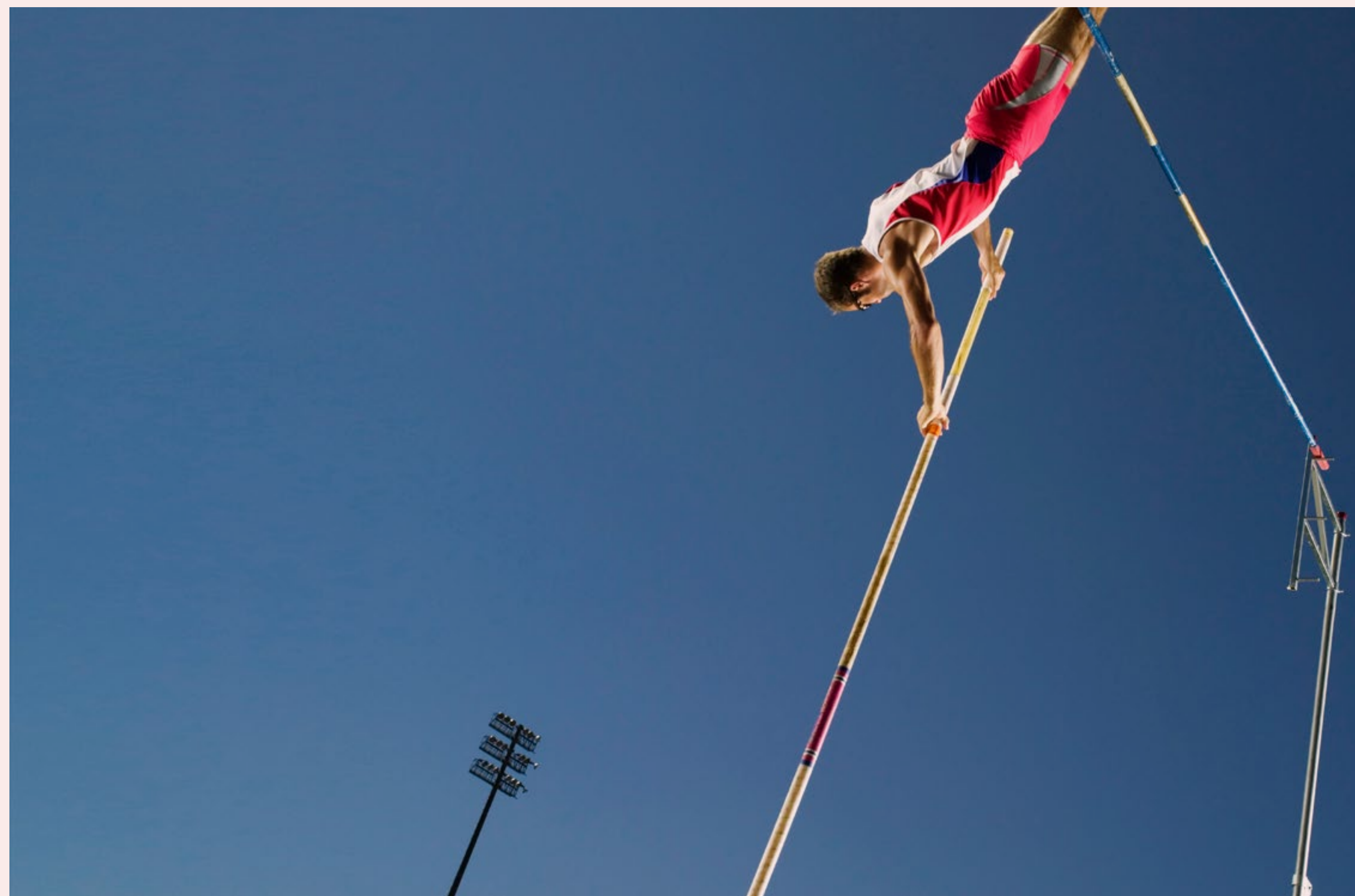
So what else is needed for a successful buy-out?

First up, trustee education.

Trustees play a crucial role in overseeing the management of a pension scheme and protecting the best interests of scheme members. Knowledge is power! Trustees need to have a thorough understanding of the process, including the legal and regulatory requirements, as well as the implications for scheme members. Trustees should undergo comprehensive education and training, from their bulk annuity and legal advisers, to enhance their knowledge and skills regarding bulk annuity transactions before embarking on the journey. With an irrevocable investment decision at hand, trustees need to have the tools in order to make the decision with confidence. A thorough understanding of the process also helps maximise the effectiveness of my next point, governance.

Effective and robust governance is essential

for the successful completion of a buy-out transaction. Meeting frequency in the run-up to a transaction is likely to be significantly greater than running a pension scheme on a business as usual basis. Trustees could therefore consider establishing a Working Group, consisting of a subset of the full board, to whom most, but not all, decisions are delegated. Strong governance ensures that the interests of all stakeholders are considered, risks are identified and managed, and that decisions are made in a timely manner. Time is of the essence in a busy marketplace as insurers have strong pipelines and slow decision-making can result in loss of transaction confidence and trustees missing out on the best deal possible.



Now, let's talk project management.

The governance structure adopted needs to be overseen by a strong project manager. We're not talking about a typical 'tick box' project manager here. Trustees are best served by having a project manager with the relevant technical and commercial knowledge to be able to identify blockages in a timely manner (and provide solutions), change speed if required, and ultimately make sure that the trustees can pull the right levers at the right time. Buy-outs are complex projects, there are multiple workstreams and multiple parties, and a good project manager will make sure everyone is on the same page and moving forward together.

Teamwork makes the dream work!

Illiquid assets, now they can complicate things a bit.

On paper the funding level might support a buy-out, but the existence of illiquid assets can muddy the waters. Firstly, illiquid assets can be challenging to value accurately. It is important to have a robust valuation methodology in place to ensure the affordability assessment is valid. Secondly, by definition, illiquid assets are not easily convertible to cash so whilst affordability might be there, paying the premium could be a challenge. But fear not! Different strategies are available, for example selling the assets to the insurer, the sponsoring employer or a third party, or deferring part of the premium to give everyone more time. All of these come at a cost and can have timing implications. Trustees on a journey to buy-out need to engage with their investment advisors, and insurers, as early as possible.

Data, data, data.

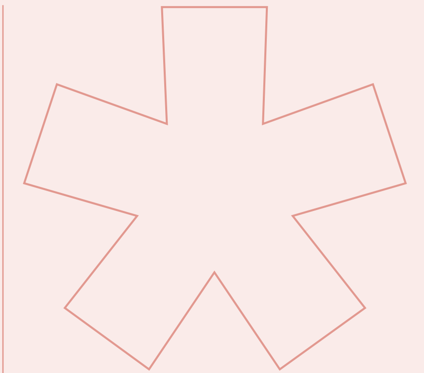
It is crucial to ensure that the member data is accurate, complete, and up-to-date and trustees need to be prepared for insurers to forensically interrogate and validate the data. The bar will be high and higher than that typically used for business as usual administration. It is important for trustees to engage early with their administrator to assess the requirements to be buy-in and buy-out ready.

Last but not least, communication and member engagement.

After the initial buy-in transaction, effective communication and member engagement are vital throughout the buy-out process. Transparency and trust are key. Trustees should provide clear and concise information about the buy-out, its implications for members, and any changes to their pension benefits. Regular updates, workshops, and dedicated helplines can help address member concerns and provide reassurance during the transition.
Open and transparent communication fosters member confidence and supports a smooth buy-out process.

So, there you have it.

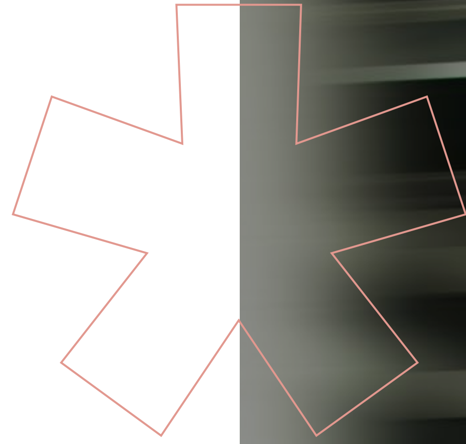
Buy-out affordability is important, but being ready for the whole shebang is equally crucial. By boosting trustee knowledge, establishing strong governance, considering illiquid assets and member data, and communicating effectively, trustees can increase their chances of a successful buy-out.



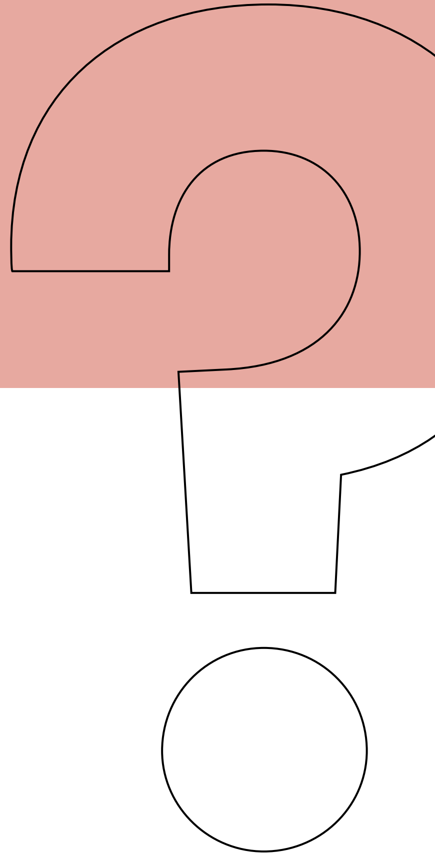
It's all about navigating the complexities and coming out on top.

Kevin Richardson
Mercer

Kevin is a Principal in Mercer's Risk Transfer team. Kevin has over 10 years' experience in the pensions industry, the last 7 of which has been within the Risk Transfer space. He has been involved in bulk annuity transactions from £1m to £2.5bn, including dealing with non-standard features such as deferred premiums and residual risk cover.



Surplus – what are the options



Elaine He
Senior Associate | CMS

Elaine is a Senior Associate in the CMS Pensions Team. Elaine advises trustees, employers and providers on a range of contentious and non-contentious pension issues. In addition to advising on day-to-day pensions matters, she has worked on a number of de-risking transactions acting for both trustees and providers. Her experience ranges from small schemes looking for efficient routes to buy-in/buy-out to some of the largest deals in the de-risking market.

Amanda Chamming's
Partner | CMS

Amanda is a Partner in the CMS Pensions Team, and has extensive experience advising providers, trustees and employers on pensions de-risking matters, ranging from vanilla buy-ins to more complex transactions, such as the conversion of longevity swaps to buy-ins. Amanda also advises a broad range of trustee and employer clients on the day-to-day running of pension schemes. Amanda was awarded "Lawyer of the Year" at the Professional Pensions' Rising Star Awards 2022.

The improving funding position of UK Defined Benefit ("DB") pension schemes

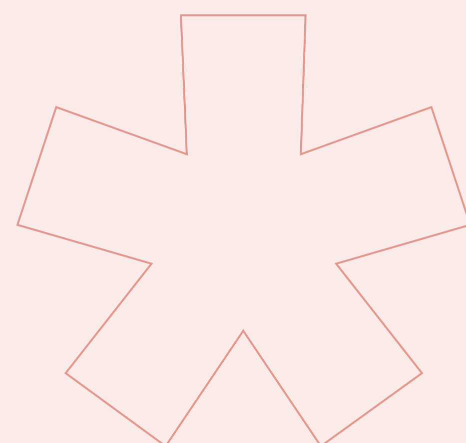
Over recent years, UK DB pension schemes have been on a journey to improve their funding positions. For a number of schemes, this journey was fast-tracked as a result of recent economic events, and as at the end of 2023, the industry estimated that UK schemes were, in aggregate, about £250bn in surplus on a buy-out basis.

This means that a new cohort of pension schemes are starting to grapple with the options available to them where there are likely to be surplus assets available once members' benefits have been fully secured.

Alongside that, there is also growing interest in this area from the current government. As a starting point, the tax payable on the return of surplus to an employer reduced from 35% to 25% with effect from 6 April 2024. In addition, the DWP issued a consultation in 2023 on options for DB schemes that touched on surplus extraction in ongoing DB schemes, and a further consultation was published in February 2024 which (amongst other things) specifically addresses the treatment of scheme surplus and options for surplus extraction.

What is a surplus?

Before delving into the potential options for the use of a scheme's surplus, it is useful to keep in mind what we mean when we refer to a "surplus". At its most basic level, a surplus arises where a scheme's assets are in excess of its liabilities. However, as the pension industry knows, there are a number of different actuarial bases for that calculation, and a scheme that is well funded on a technical provisions basis may still be short of being able to buy-out benefits with an insurer. This article focuses on the options available where surplus assets remain once members' benefits have been fully secured.



Options

Before trustees are able to fully consider the options available to them in relation to a surplus, it is important to understand the relevant provisions under the scheme's rules. Typically, the scheme rules will prescribe who holds the power (i.e. the trustees, employer or both) and what actions they are able to take with any surplus assets.

DB benefit improvements

One option may be to provide benefit improvements for scheme members out of the surplus. Whilst this is a simple concept, it can often be quite complicated to implement in practice.

There is a question of the scope and nature of the benefit improvement. Will the surplus be used to enhance benefits for all members or specific groups of members? Will it be implemented through a one-off increase to benefits, or is it possible to structure the enhancement so that members receive a lump sum? When deciding how to augment member benefits, trustees will need to ensure that they make informed decisions taking into consideration all the relevant factors, which will also provide them with a good defence if any member complaints arise.

Timing is also a key point – if the trustees are comfortable that there are sufficient assets to enable them to make augmentations as part of the buy-in process, then it may be that they are able to use some of those surplus funds to deal with issues that arise during the data cleanse, or to simplify benefits in order to make them easier to insure and smooth the path to buy-out. In these circumstances, it would be necessary to consider who holds the general power of augmentation under the scheme rules. If a buy-in has already been entered into, and benefits are being augmented prior to buy-out and winding-up, then trustees will need to engage with their insurer to confirm that such augmentations can be insured and administered, and to identify any additional premium that may be payable.

Beyond considering what is affordable with the surplus available, trustees must also be mindful to ensure that they are acting within the scope of their duties in deciding how to structure a benefit improvement exercise.

Funding Defined Contribution ("DC") benefits

As an alternative to augmenting DB benefits, employers may be considering whether they can fund future DC benefits using the surplus in the scheme; this way, the employer can access the additional funds without incurring the tax charge on a return of surplus. As with all the other options, whether this can be done will depend on the scheme rules in question, and the agreement of both the trustees and the employer. It may be more straightforward in a hybrid scheme where members already have DC benefits.

However, even a pure DB scheme could look into, for example, setting up a DC section to provide DC benefits going forward.

Funding DC benefits is not a short process, therefore sufficient time needs to be built in for the project to take place.

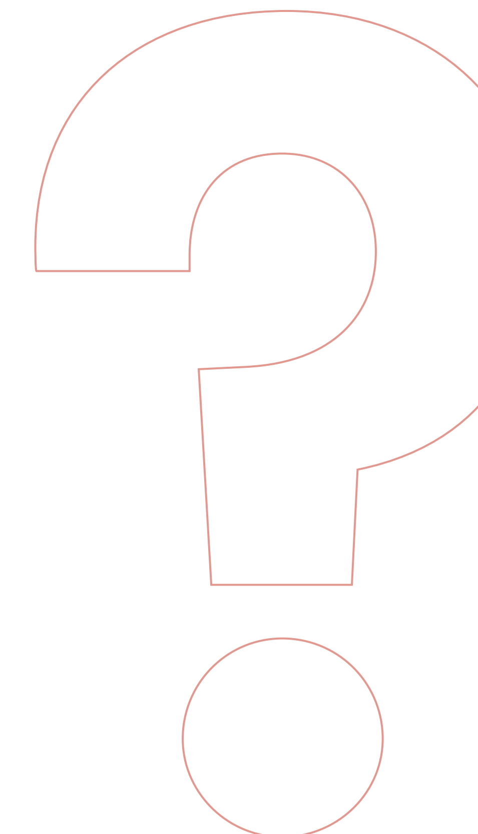
Returning surplus to the employer

This option has been the focus of recent attention, including in the 2023 Pension Ombudsman Bristol Waters case, which reaffirmed that it can be appropriate for surplus to be returned to an employer depending on the circumstances.

The first question in considering a return of surplus to the employer is what is permitted under the relevant scheme's rules. Most scheme rules will cater for the ability to return surplus to the employer as part of a scheme wind-up once all members' benefits have been secured, however, there are some scheme rules that only provide for the augmentation of members' benefits. As such, it is important to understand the scope of the power under the scheme rules early on in the process.

Beyond this, anyone considering a return of surplus to the employer will need to bear in mind the legislative requirements before a surplus can be returned, which include a member communication process. As part of that process, members have the opportunity to make representations to the Pensions Regulator if they have concerns about the return of surplus, so any trustees or employers will need to be prepared to manage that engagement. Employers will also want to bear in mind the tax charges that arise on an authorised surplus payment, although as flagged earlier this reduced to 25% from April 2024.

What does this mean for a scheme ready to buy-out



As with all aspects of buy-out journey planning, the key message when it comes to dealing with a surplus is thinking ahead. Trustees and employers will need to consider early on if there is likely to be any meaningful surplus that will arise following completion of a buy-out and, if there is, consider what options they would like to explore further.

To the extent that the scheme wants to undertake a benefit augmentation, the trustees will need to think about what kind of augmentation is envisaged and the timing to implement this – for example, at the buy-in stage, during the course of a buy-in or at the point of buy-out.

The contract terms will also need to cater for the relevant benefit augmentation approach.

Even where the plan is to return any surplus after buy-out to the employer, a scheme approaching buy-in will still want to think ahead to their communication strategy and how best to manage this approach with members. It will also need to consider how the timetable to buy-out interacts with the communication requirements around return of surplus and any target date for the scheme wind-up to be completed.

Is price the most important thing?

Now that many more schemes are in surplus, does this change what is important to trustees when going to buy-out? Would trustees pay more for better member experience?

For trustees, ensuring the security of member benefits is paramount.

Trustees engage with insurers to reduce the risk that member benefits are not paid in full. Those conversations will usually begin with affordability – 'are we well enough funded to approach the market for insurance pricing, and if we are, do we think that is in the best interests of our members compared to running the scheme on?' But that is just the start of the conversation. If insurance is affordable and desirable, and several offers are on the table, the next stage is to decide which insurer to go with…

…and that is when a range of other factors comes into play.

The weighting of other factors in these decisions will likely depend on the trustee's priorities for running the scheme until now. For example, with cyber security posing an increasing threat to schemes, some trustees and sponsors will not consider insurers which don't meet the strictest data security requirements. Others may have clear requirements for ESG credentials, based on their current investment beliefs and decisions to date.

Member experience will also be on trustees' minds. For example, trustees who have worked hard with their administrators to ensure good levels of member service and have invested in online member portals where members can get retirement quotes and transfer values, will be reluctant to move to a situation where these facilities are no longer provided.

The importance of member experience

Member experience covers all the member's touchpoints with their pension provider, from the communications they receive to the interactions they have with the administrator. This can be a deferred member seeking a retirement quotation via a member portal or a contact centre, a request for a transfer value which may progress to an actual transfer, or support with a retirement or death of a member. All of these are complex processes which need to be carried out accurately and quickly, and well communicated to provide good member service. Clearly, in some of the more challenging situations such as bereavement or where there is an elderly or vulnerable member, the level of care needs to be stepped up and will require a tailored approach.

Good administration leads to good member experience. But what does good administration look like in practice? It means automating the processes that can be automated, to improve accuracy and speed, and having multiple means of contact, from well-trained staff answering calls and emails to online portals providing real-time information.

Insurers have the scale when it comes to administration, whether it is delivered in-house or outsourced. It is therefore reasonable for trustees to expect insurers to use that scale to improve member satisfaction. This can be in the form of demanding Service Level Agreements ("SLAs") requiring well-resourced teams to deliver them, through to investments in technology to improve speed and accuracy, which can all be made cost-effective by having a large client base.

When it comes to communication, insurers can support trustee communications at each stage, from the buy-in (if indeed the trustee does communicate around this), to any benefit changes, to communication of the move from trustee to insurer on buy-out.

Simple, reassuring communications at each of these stages will minimise concerns and queries from members, reduce administration distraction at a time of already increased resource demands, and also arguably potentially lower queries or risk after buy-out.

How can trustees ensure that insurers are focusing on these important areas? Trustees should ask about member service Key Performance Indicators and performance against these factors, as well as existing and planned investment in a variety of member service activities – from the treatment of vulnerable members to investment in live online quotation tools. Trustees should also ask how member feedback is gathered and how it is used to improve services.

Member experience versus pricing

So how does member experience relate to price? If there is little difference between pricing and other factors among insurers, but one insurer has a better offering for members, that provider would very likely be in a stronger position. All else being equal, trustees would be much more comfortable knowing their members were likely to be happy with the service after the transaction, receiving at least as good information and turnaround times as now.

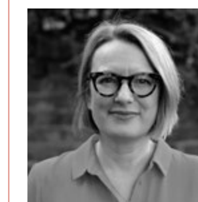
Would trustees be happy to pay more for better member experience? If an insurer offering better member experience was marginally more expensive, it may still give them an edge as member experience definitely has a real value, however it would obviously depend on the size of the price difference, and the alternative uses of cash. For example, if a funding surplus is likely, the decision would depend on other potential uses of the surplus which members may also value, such as benefit enhancements.

Trustees are well-accustomed to reviewing member feedback, including occasional complaints. Members will start to be impacted by the insurer's administration from the point of buy-in – even if the current administrator remains the point of member contact until buy-out. If insurers can turn around quotations quickly, or feed existing member administration platforms with live quotations, then member service can carry on largely as before. If delays are introduced into SLAs due to lengthened times for calculations, this can lead to complaints from members. This is uncomfortable for both the trustee and the sponsor (particularly if they have prided themselves on their employer brand) and is something they will want to avoid.

When administration switches fully to the insurer at buy-out, the trustee is no longer involved as the intermediary. Whilst the trustee will have worked hard with the insurer to make the move as seamless as possible, members may still contact the sponsor to make complaints – just when the sponsor thought they had severed the pensions link.

Based on their own experience working with administrators, trustees know that getting administration right and providing a good service are not easy. They know the administration industry is currently stretched for resources, exacerbated by industry-wide projects such as GMP equalisation and pensions dashboards.

Recognising the real value in good member experience, trustees will likely give it weight in the decision-making process when going to buy-out.



Victoria Gibbard
Professional Trustee at Capital Cranfield

Victoria is a Professional Trustee with Capital Cranfield, working with a range of UK DB and DC schemes with assets from £20m to £2bn. Her work with schemes in the latter stages of their lifecycles has included buy-in/out for DB schemes and transferring DC assets to master trusts.

Prior to becoming a Professional Trustee, Victoria held senior Corporate Reward and Benefit roles with a number of multinational employers, including PepsiCo, giving her a strong understanding of member needs and communications, as well as experience of working with diverse sponsor stakeholders.

Victoria also sits on the Board of Capital Cranfield.

The views expressed are those of Victoria and do not represent any statement of policy by Capital Cranfield Trustees.

Will jumbo deals tip the marketplace

Is there still room for small transactions ?

Verity Hastie
Hymans Robertson

Verity is a senior consultant in the risk transfer team at Hymans Robertson LLP. She has 15 years' experience in the risk transfer market, holding previous positions in the business development teams at Rothesay and Paternoster with responsibility for origination and execution of bulk annuity transactions.

Verity now focuses on providing strategic endgame advice to pension scheme trustees and corporate sponsors. Since joining Hymans Robertson in March 2023, she has led transactions covering liabilities in excess of £1.5bn, including for two pension schemes with FTSE 100 sponsoring employers. She is currently working with schemes with overall liabilities of more than £10bn.

Pension scheme risk transfer transactions are getting bigger.

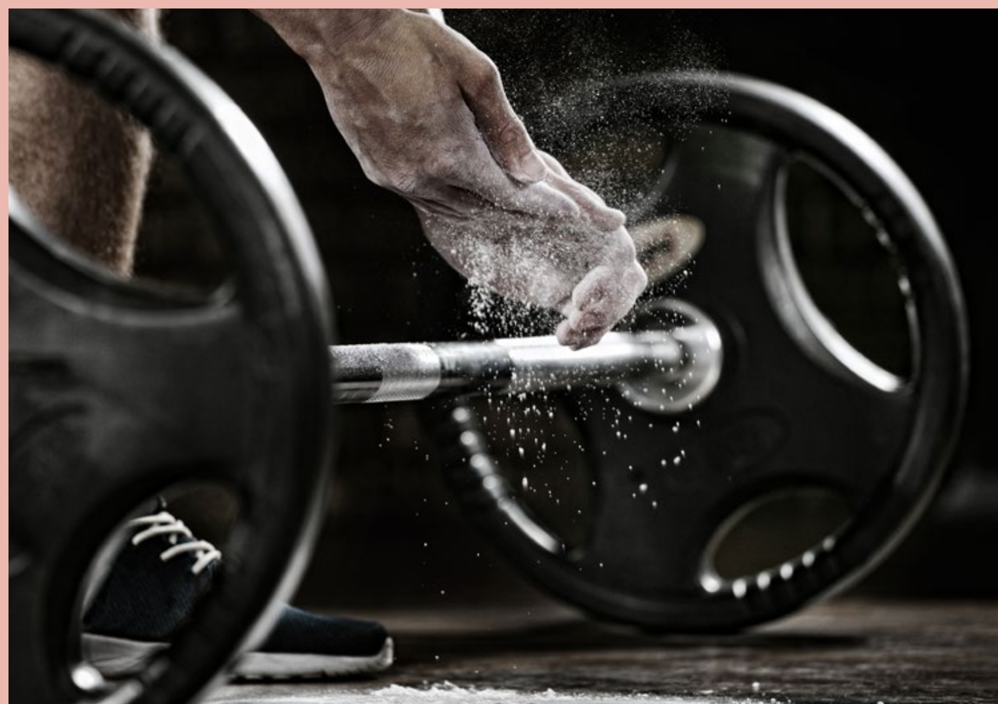
Two recent deals illustrate this trend: Rothesay's £4bn buy-in for the Co-operative Pension Scheme and L&G's £4.8bn buy-in for the Boots Pension Scheme. These follow on from the largest buy-in to date, which completed in 2023: PIC's £6.5bn buy-in covering the liabilities of two of the RSA Group's pension schemes.

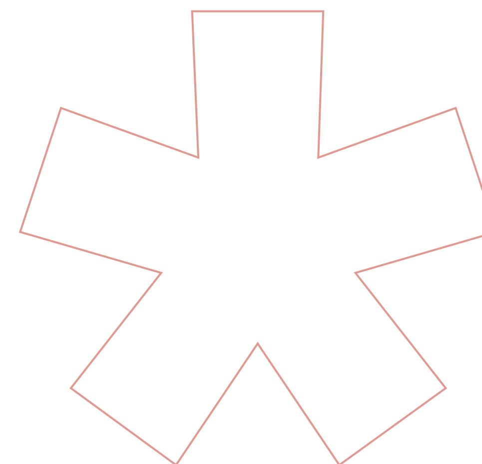
In the first half of 2023, nearly 60% of the bulk annuity market by value resulted from five deals in excess of £1bn. As many defined benefit pension schemes have become better funded over the past few years, many are targeting buy-in and buy-out, including the very large. As insurers continue to compete for the 'largest ever' title, we will, as a market, need to continually recalibrate the thresholds by which we measure transaction size. However, what is clear is that large and perhaps jumbo deals are likely to continue to drive market volumes in 2024 and beyond.

A large transaction puts demands on an insurer's pricing, operations, investment and management teams. Large transactions require access to capital and attractive, long-dated assets at significant scale and a considerable focus is needed to ensure an optimal experience for the scheme's sizeable membership. However, some insurers are still choosing to chase very large deals and shift their appetite away from smaller transactions.

Changing market conditions, in particular over the course of 2022, have improved the availability of capital within insurer portfolios to write new business. Further, as the insurers' back-books mature, prudence within insurers' capital reserves can be freed up and, all else being equal, can be allocated for new transactions. These mega deals may therefore not create the capital concerns that they would have done in the past.

The overriding complexity of bulk annuity transactions, regardless of size, means some insurers may view the extra effort that large, and even jumbo, transactions demand as being 'at the margin', particularly given the increase in average transaction size over the years. For insurers with processes and asset sourcing capabilities that are more easily scalable, writing significant volume through a single transaction is likely to deliver greater upside.





Appetite for small scheme transactions

This trend might leave pension scheme trustees and sponsors wondering about the prospects for smaller transactions. It's worth remembering that not every insurer in the bulk annuity market is focusing on large transactions. Some are investing in making operations more efficient simply to keep up with demand from small and medium sized schemes.

Many insurers are streamlining the quotation process, so they can more easily engage with the market, particularly at the smaller end. This drive for efficiency brings some standardisation, limiting flexibility for smaller schemes to negotiate bespoke commercial terms. Consequently, some schemes will consider entering into a transaction based on pre-negotiated contracts.

It's worth remembering that not every insurer in the bulk annuity market is focusing on large transactions.

Under this approach, trustees and sponsors need to rely on their advisory teams to ensure they are getting a fair deal. The good news is that insurers are incentivised to make their standard terms attractive if they wish to continue to write business at this level. This will be particularly important for those insurers who have invested in systems and process improvements. The growth of independent and sole trustees in effect acting as repeat customers for insurers will help ensure the market standardises at an acceptable level.

Exclusive processes

Some insurers have been reluctant to quote on smaller transactions without exclusivity. An exclusive broking process is one where a scheme pre-selects one insurer and requests pricing only from that insurer, rather than approaching the whole market. As above, trustees and sponsors will look to their advisers to ensure that they engage with the right counterparty and that they achieve good value for money.

An exclusive broking process may be the right approach for some schemes and will remain a requirement for some insurers. However, as exclusivity is not a pre-requisite for all insurers, small schemes should also consider a competitive process. As insurers become slicker at quoting and transacting, we expect some of those who might otherwise have sought exclusivity to become more willing to engage in competitive processes for all transaction sizes.

New entrants and new solutions

The opportunities that the busy market presents are likely to attract providers that aren't already active in pension scheme risk transfer – as shown by M&G's re-entry in 2023. A new entrant may be unlikely to go for large transactions, at least at first, and so it could boost supply for small and medium transactions.

Insurers are likely to dedicate some innovative deal structuring to very large transactions, as they might feel these deals would be worth the effort. Insurers have a strong incentive to find solutions to the complex or unique problems that large schemes often face – for example, a variety of illiquid assets.

Matching Adjustment reserving requirements remain the binding constraint for insurers in delivering structuring solutions for illiquid assets, and therefore the cost to a scheme can often be punitive. The PRA's recent consultation paper setting out proposed reforms to the asset requirements for Matching Adjustment eligibility presents some opportunity for insurers to invest in new asset classes. This could, in turn, mean insurers can offer greater flexibility to take on schemes' illiquid asset holdings, and potentially at a lower cost.

However, a lot more work is likely to be required before we see the benefit of this come through as part of any bulk annuity transaction. Once these solutions have been tried and tested, insurers may extend them to other schemes, so the market as a whole could benefit. More innovation would lead to a wider range of solutions, and so a move away from a standard approach – ultimately, all schemes could benefit.

Making the most of opportunities

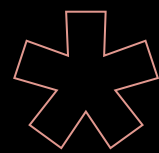
Several insurers are chasing the same high-value deals, so some will inevitably lose out to competitors. In such an active market, a well-resourced insurer with a transaction team in place will want to move quickly to another, and perhaps smaller, deal if it doesn't win – particularly if it has the capital and assets already lined up to back a transaction. This could open up opportunities for schemes that are transaction-ready and have governance structures in place to move quickly.

Trustees and sponsors may also be concerned about how to attract the attention of insurers that might already be struggling to keep up with demand. As covered elsewhere in this report, risk transfer advisers are adapting processes to ensure they remain fit-for-purpose in a fast-changing market and to give those schemes that want to pursue a de-risking transaction the opportunity to achieve a good outcome for their members, regardless of size.

27 | Rothesay | The journey to buy-out 2024
Welcome to the endgame

Chapter 1
A changing marketplace

Entering the BPA market:



*a risky gambit, or checkmate for existing providers?

A relatively familiar neighbourhood chess game has been playing for years with the same eight players on the park benches since 2016.

They understand the rules, they understand each others' strategies and have settled into a comfortable yet highly competitive routine. There are (just) enough chess games going around to keep most of them happy most of the time.

Suddenly, this serene park is bustling with potential new players who want to bring their own chess boards and to increase the number of games in play at any one time.

They have new moves they want to try, unknown strategies to deploy. Can they take on the veterans, or will they find that the game they have wandered into is much more difficult to win than they expected?

At the EY organisation, our bulk purchase annuity (BPA) consulting team is currently supporting several firms who are at various stages of entering the UK BPA market. In a market that had not seen a new entrant in seven years, insurance companies M&G and Royal London have both entered in the last 12 months, and others may not be far behind. What is the sudden appeal? What can we learn from these entrants about the future of the market?

The most straightforward answer is growth. The UK BPA market is one of the few areas within the European insurance industry that is experiencing significant growth in demand, driven most recently by the higher interest rate environment acting to reduce pension scheme funding deficits and increase the affordability of an insurance transfer. In a market that in recent years has delivered £20bn-£30bn in annual volumes, we now see consistent market forecasts of £50bn-£80bn per year over the next 5-10 years.

Some new entrants believe that this increased demand will be difficult for existing providers to service, giving an opportunity for them to add more capacity to the market without necessarily diluting profits. Others are aiming to take advantage of one or both of two specific areas of the market which may be able to generate excess returns. The first is the so called "mega deals", large and complex transactions which generally require greater innovation and flexibility from the insurers to accommodate the features of the scheme. The second is the market for small schemes, which are arguably underserved and becoming increasingly so as demand has spiked, as many providers have raised the thresholds at which they will quote.

Other than growth, the BPA market is also an opportunity to deploy complex assets. At its core, making a return on BPA business depends on investing a large portfolio of assets in a way that maximises return whilst matching the liabilities of the scheme and managing the risks to the insurer. Some prospective new entrants have little UK insurance experience, but they do have strong capabilities in sourcing and managing assets, which they believe could give them an edge in winning business.

The chess game is about to get a lot more interesting.

Regardless of the reason for entry, all prospective new entrants face some significant hurdles to success. In our chess analogy, the entrance to the park has several padlocks; having just one or two keys might not be enough to get you in. I would like to highlight two of the biggest padlocks entrants will need to unlock.

1. The first is the regulatory costs and timelines involved. If you are an existing insurer, it is already difficult enough - under Solvency II, you may need new internal model approvals, Matching Adjustment approvals, or internal ratings methodologies. Each of these approvals can take months or years at significant cost, with no guarantee that you will be successful in the market when you have acquired them all. If you are not yet a UK insurer, you will additionally need to go through the regulatory authorisation process, which can add even more time and effort (albeit with the potential that this process will be streamlined through the changes coming to UK insurance regulation).

2. The second padlock is talent. Bulk annuity business is complicated and resource-intensive. The liabilities are complex, with each scheme typically having its own bespoke benefit specification and dataset that needs to be checked, transformed and modelled. The assets are complex, with a wide variety of illiquid assets now commonly deployed by insurers that require capital modelling, internal ratings and ongoing management. The regulations are also complex, particularly in the areas of credit risk and funded reinsurance. Acquiring or building all of the talent necessary to navigate this complexity successfully is difficult, and generally requires encouraging talent to leave the existing pool within your competitors or a long timeline to develop it.

Once all the padlocks are unlocked, there is still no guarantee that you will win a game. The incumbents have a seven-year head start in understanding and adapting to the market under Solvency II, and the broader landscape will continue to change around them. For example, other new entrants or existing providers may be adopting the same strategy you are, or the superfund model may begin to draw volumes away from the insurers. The Department for Work and Pensions is also consulting on the setting up of a public consolidator for schemes that are unattractive to commercial providers, but with the definition of unattractive still to be agreed. Firms have to be ready and willing to make mistakes, learn and change course quickly.

In any market that has been dominated by a few players for several years, the entry of new competitors changes the dynamics. It can lead to increased choice and better pricing for customers, in this case pension schemes. It can force existing providers to adapt, innovate and up their game to stay on top. The newcomers have an exciting opportunity to disrupt the status quo, but they must prove their viability and value in a market where trust and brand are critical, and these currently lie with the established players. The chess game is about to get a lot more interesting.

Chris Anderson
EY

Chris is Head of Bulk Annuity Consulting at EY, where he specialises in supporting firms who are seeking to enter the market. He has worked with five firms over the last three years at various stages of their journeys from initial market exploration through to regulatory applications and delivery of operating models. He also supports existing BPA providers who are looking to transform their business to keep pace with the changing market.

Why lifeboats are made to be unsinkable

The RNLI website tells the fascinating story of the history of lifeboats. Born out of tragedy when the ship Adventure ran aground during a violent storm in 1789, a competition was held to design and build an unsinkable boat. The intent was never again to be prevented from bravely putting out to sea in treacherous weather to save those that needed help where no one else could reach them. Today, the RNLI all-weather boats self-right and it is inspiring to see videos of the crews head out in tough conditions and I expect a comfort to any who may run into trouble at sea.

Our own pensions lifeboat, the PPF, has been a resounding success. Since 2005 it has protected 300,000 pension scheme members that may otherwise have suffered financial hardship after the insolvencies that sunk their sponsors. The government is now considering a new role for the lifeboat - as a public sector consolidator of solvent sponsors' pension schemes.

This raises the question of whether this change in design is needed, and whether it is in members interests?

Wayne Segers
XPS Pensions Group

Wayne is a Partner in XPS Pensions. In his role as Head of XPS Pensions Solutions, Wayne has led XPS's engagement with the government on its consultation on options for DB schemes covering both run-on for surplus and the public sector consolidator. Wayne also advises a number of XPS's corporate pension clients on setting and implementing pension strategy.

Government aims for a public sector consolidator

The case put forward for a public sector consolidator is twofold:

- that this would introduce another option for trustees of DB schemes to secure benefits, particularly those schemes that cannot do so in the commercial market because they are unattractive to providers (due to size or benefit complexity); and
- it would lead to the pooling of many small schemes which would then have the scale to invest in productive assets.

Schemes would be able to enter if fully funded on a "gilts + 75 basis points" basis, or if there is a deficit on this measure, schemes could enter with the employer paying a fixed schedule of payments to make good this deficit over a period of time.

Ultimately, the new public consolidator would be underwritten by UK taxpayers.

Why lifeboats are made to be unsinkable

Will this new boat float?

Access to consolidators

The premise of the public sector consolidator is that it will help schemes that are unattractive to commercial consolidators - be that insurers, superfunds or master trusts. The argument is that there are schemes who are too small, too complex or too underfunded to access a consolidator. None of these stand up to scrutiny. In over 50 cases XPS has recently taken to market, across a range a scheme sizes, none have failed to obtain a quote. Those the insurers tell us fail to get a quote are typically not properly prepared.

On benefit complexity, the PPF is proposing it would harmonise benefits into a simpler structure. This risks either creating winners and losers of members, or making schemes more expensive. The former can lead to legal challenge that taxpayers will end up funding, or weigh down the new boat with additional costs.

Finally, if a scheme is underfunded, this is not a risk to members' benefits while a solvent sponsor remains. Insurance costs and funding levels do naturally improve over time. Instead, it risks the public sector consolidator enticing schemes to leave the safety of their sponsor on the shore to climb aboard the new boat and sail out into uncertain waters before they need to.

Investing in productive assets

XPS considers that it is not the responsibility of private sector DB pension schemes to ensure growth of the UK economy; it is their role to provide their members with their pension promise. Members' benefits are not directly dependent on returns in the same way that they are in DC schemes. The main risk in DB schemes is sponsor insolvency before benefits have been secured in full.

A worry for the public sector consolidator is that, having encouraged schemes to leave their sponsors through attractive pricing, the new boat sails out into potentially choppy waters which will be more perilous the greater the pressure for the consolidator to invest in more volatile growth assets.

All of this will be underwritten by the taxpayer. The government has proposed taxpayer exposure will be limited. Who then will rescue the new PPF boat should it run into trouble? Will the government politically allow one PPF boat to sink when the public may not draw a distinction between them, or would it ultimately have to step in, expand support and make that boat self-righting? The alternative is to have the existing PPF lifeboat step in. If the public sector consolidator has become large, that risks our current pensions lifeboat remaining unsinkable. The assets of small schemes potentially in scope are five times the current size of the PPF.

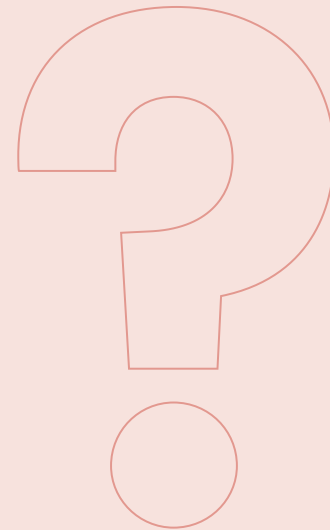
A better expanded role for the PPF

XPS is supportive of a developing market of consolidators. We also believe there is a valuable extended role for the PPF as a lifeguard for viably funded schemes that run into trouble due to sponsor insolvency. The PPF could safely help those schemes to the buy-out shore, giving members the chance to receive full benefits where their sponsor has failed.

We do not, however, think there is a case for a taxpayer underwritten public sector consolidator.

What does this changing market mean for administrators

What does this changing market mean for administrators



The current environment

Administration has often been considered something of a poor relation in the world of pension schemes. It's always been easy for a trustee board to see the value in their investment consultant and asset managers; or understand the importance of having an experienced Scheme Actuary to guide them through valuation negotiations with the sponsoring employer; or legal advisors to ensure they understand their obligations as caretakers of the scheme. **But the data? Well, the data would take care of itself.**

Or would it?

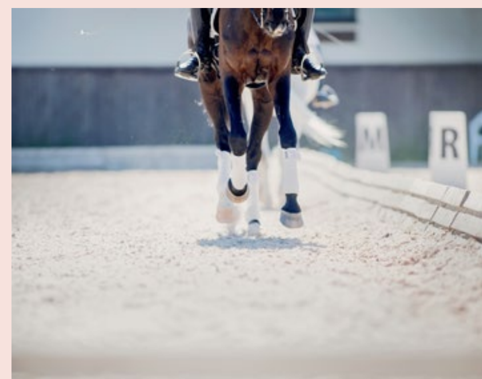
After decades of tight budgets leading to dropped cleanse exercises, not enough investment in technology and automation, and a fight for talent, scheme administration finds itself in a difficult spot.

In administration, the people are as important as the data systems. However, the forced home-working of the COVID-19 pandemic showed that it was actually possible for administrators to work remotely, which opened up more opportunities and created a much more transient administration workforce – great for the individuals, but bad news for trustees that lose knowledge and experience on their schemes. Furthermore, insurers are guilty of shrinking the resource pool. By bringing administrators into their teams (likely seen as the growth area in the industry and where teams are more stable), they have attracted skilled administrators away from the ongoing scheme world.

For some schemes, the standards of day-to-day member administration are well below where they should be, never mind contemplating the extra work involved in implementing a risk transfer arrangement.

The big barrier to achieving buy-out is no longer scheme funding levels – where improvements have accelerated timelines to buy-out as much as 5-10 years. Whilst illiquid assets are a barrier, insurers are increasingly able to find solutions. Instead, it is now the ill-fated combination of poor data and a lack of administration resource which acts as the main blocker to buy-out.

With schemes now racing to the bulk annuity market to seize market opportunities, and sponsors keener than ever to break free of the pension burden, this elephant in the room has become impossible to ignore.



How does this affect the transaction?

It goes without saying that the quality of the data and the level of advance preparation will have a big impact on a transaction. From the trustee and sponsor perspective, two areas are key: the upfront price, where assumptions are needed in calculating the premium (lower experience data and less reliable data leading to greater prudence, which can knock onto reinsurance pricing too); and, of course, the extent of data cleansing actions the insurer will require the trustee to complete (which will impact on any balancing premium owed further down the line, creating price uncertainty as well as extending the overall timeline).

But administration touches all stages of a risk transfer transaction, and there are some more subtle points to factor in that put additional pressure on the administration team:

- Accessing data needed in the exclusivity phase to complete due diligence can lead to delays in signing the contract and impact on price-locks, leaving trustees exposed to more market risk.

- Managing the impact on member experience, particularly where there is a deferred population included (which is increasingly the case). There will be additional processes expected of the administration team to incorporate member option factors; and the usual online portals may be unavailable during this time, increasing the activity directed to your administrator (plus news of the transaction itself may lead to increased volumes of enquiries).
- Additional regular reporting and tracing (particularly for the population past retirement age) will be required by the insurer.
- The data cleanse actions to be carried out by the administrator on behalf of the trustee can vary wildly, but often include work to calculate contingent spouse's benefits, or re-visiting Barber equalisation – areas that will potentially involve digging around paper files and old systems.
- Whilst GMP equalisation needs to be completed by schemes regardless, there will be additional work in providing the data and any supplementary information to the insurer to ensure they can administer the benefits following buy-out.
- For some schemes, Winding Up Lump Sum (WULS) exercises can reduce the premium and are often a welcome opportunity to cash in benefits for members. However, the bulk of the work required to run the exercise will sit with the administration team, including population checks, bulk mail merges, handling queries, monitoring responses, running payment security checks and updating records.
- The administration team will be vital in managing member communication exercises, from general updates on the transaction, to write outs related to data cleansing actions and discharge notices ahead of buying out.
- Throughout the process, the scheme administrator will also of course be managing the transition to the insurer's administrator – providing multiple data extracts, image files, AVC and payroll information, and addressing queries.

What can we do?

Administration capacity isn't going to grow overnight to match the surge in activity in the bulk annuity market, and many schemes are coming to market with their legacy data issues unresolved. This leaves trustees (and insurers) needing to find alternative means to support the successful and timely transition of schemes to an insurer, and ease the pressure on the market that these transactions create.

This starts with bringing the administrator to the table – include your administration team in planning and discussions at the feasibility stage if possible, so they understand the requirements and get the right people available.

Ensure open conversations on costs and resource are had in the early stages, and be prepared to pay. Often the focus is on the premium and all the work involved in agreeing the contract, but during exclusivity (or earlier), you should get to grips with the cost implications from all of your advisors beyond inception date – don't underestimate the extra work involved.

Consider the structure of the deal: single premium residual risk deals, for example, will increase the due diligence effort significantly and typically mean that the insurer will pay the benefit cashflows requested by the trustee, but this is predicated on the timely and accurate flow of information from the administrator from day 1, which is a significant ask.

As more and more transactions are completed, scheme administrators are building up expertise in the reporting and data that insurers require, often having specialist teams that can run the data cleanse exercise. Trustees can leverage this by sticking to standard terms as much as possible. Bespoke deals and drawn out timelines will undoubtedly lead to more work operationally.

Whether at the client, or outsourced to a consultant or governance solution, have a dedicated project manager to partner with the transition manager at the insurer. This will be money well spent to maintain the momentum needed to meet each milestone and support the administrator in managing and prioritising their responsibilities.

Ask yourself, what is really important to you? For example, does the premium saving of a WULS exercise really offset the cost and effort of running the exercise at the risk of increasing the timeline?

Find opportunities to combine necessary processes, cleanse activities or communications into existing tasks. Technology and AI no doubt have a role to play here, too.

Consider the impact on resource that the method of equalising GMP will have. For example, dual record methods are almost certainly a heavier lift than conversion, both before and after buy-out.

It is in our collective interests for bulk annuity transactions to be completed as quickly as they can be, and for trustees and insurers to be mindful of the wider view when making their decisions. Otherwise, we are all continuing to contribute to the ongoing capacity challenges.

Your administrator really does hold the key to a successful risk transfer transaction.

So whatever stage you are at in your risk transfer journey, bring them in and start showing them some love – they really need it!

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.

Getting your scheme's data in shape

Getting your scheme's data in shape

With the bulk purchase annuity market being busier than ever before, what can trustees do to prepare the scheme's data for being 'buy-out ready'?

As market conditions have changed and more schemes are able to afford to move to buy-out, it is more important than ever that schemes are prepared as early as possible to transact. The cornerstone of running any pension scheme is good administration; often taken for granted and undervalued. Good administration underpinned by accurate calculations and clean data is vital for a positive member experience at retirement, but it is also key for a smooth transition to buy-out.

Data validation reporting

Your administrators should have a suite of data validation reports to check the presence and accuracy of key member data items. This has been a requirement of the Pensions Regulator for several years so this process should already be embedded, with results published at least annually. Reporting should include:

- identifying missing address and contact data;
- tracing missing members;
- validating existing address and contact data;
- validating pension tranche data splits and labels; and
- regular mortality checks including overseas retirees.

Where gaps and data issues have been identified, ensure steps are taken to correct and then maintain the completed data.

In addition to generic data tests, the administrator should be able to advise trustees on any scheme specific tests and run them where required. This may include validation tests such as correct application of scheme specific early or late retirement factors, scheme specific revaluation or a scheme underpin calculation, etc. Alternatively, if you aren't sure if your data is accurate, you could request a sample audit covering a selection of members to give a high-level data quality rating.

Another key data set when looking to move to buy-out is ensuring up-to-date spouse's data is held on the first 'life's' record at the point of retirement, so it is available upon death to set up spouse's benefits. Most administrators do not calculate this at retirement, but at the point of death, which can create a pre-transaction dependency on creating the data or bringing it up to date.

Finally, GMP equalisation. Make sure your administrator has completed GMP reconciliation, rectification and equalisation activities, and that the resulting data has been loaded to the administration platform accurately. It is also critical not to forget about meeting the responsibilities for past settlements through top up payments. If this exercise is due to happen closer to the point of buy-out, which is still not unusual, engage with your selected insurer and agree the format of the equalised GMP data. It may be possible to provide this as a separate data load if it is not possible to load this to the administration platform in time.

Ask your administrator to run data cleansing exercises early and ensure any inaccurate data is corrected, missing data is provided, and all data is always kept current. Get in early to beat any rush for data cleanse resources as your administrator is likely to have a number of clients on a de-risking journey, and you will want your scheme to be high on your administrator's priority list. Do this by asking for the reports to be run and agreeing a clear scope and follow up actions to resolve key data issues.

Member engagement

Trustees can and should encourage member engagement via their website, including asking members to keep contact information up-to-date. Another useful exercise is to gather marital status information by writing out to members or using a tracing agency to provide marital status prediction data, or even better asking members to update this themselves via the scheme's website.

Documenting administration practices

Another task to help get ahead of the game is documenting any non-standard administration practices, as often, over time, administration practices can deviate from the scheme's Trust Deed & Rules. Having knowledge of this, and keeping up-to-date documentation on the administration processes followed, will become useful when a benefit specification is produced for buy-out purposes – particularly when the administrator is asked to review the benefit specification being insured as part of a bulk annuity transaction.

Pensions dashboards

It is also worth noting that pensions dashboards connection dates are on the horizon. Improving data quality and tracing missing members will help to mitigate the risk of large numbers of queries from missing members when your scheme connects to the dashboards ecosystem and becomes publicly accessible. This could otherwise be an unwelcome distraction for your administration team if they are busy working on dashboards data-related queries, instead of progressing usual administration tasks and projects related to the buy-out journey.

In summary…

Having better quality membership data provided at the initial transaction quote stage could well result in a smaller balancing premium following the buy-in data cleanse phase, ultimately resulting in a smoother and quicker journey from the initial buy-in transaction to issuing individual polices and moving to full buy-out, minimising any unwelcome surprises along the way.

Engaging with your administrator and discussing plans to reach buy-out is key

Alex Glasier
WTW

Alex is Head of Insurance in WTW's Outsourcing GB line of business. She has over 26 years' experience in pensions administration working on a range of DB and DC schemes, more recently focusing on insurance transactions working with Rothesay on the ASDA buy-out, the National Grid buy-in and a number of other transactions.

PwC
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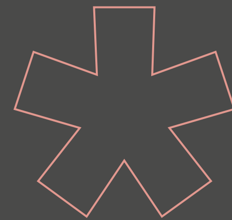
What's to come – predictions for the future

What's to come – predictions for the future



PwC

The pensions risk transfer market has been on a record-breaking spree yet again in 2023, and this momentum is likely to persist.

Here are my top five predictions for the future:

1. Increased demand for buy-ins will mean approaching the market requires care

The funding levels of pension schemes remain unprecedented and exceptionally high. To illustrate this, over the last year, PwC's Buyout Index is consistently showing record levels of surplus of over £200bn for the UK's 5,000 corporate Defined Benefit pension schemes. This trend, coupled with insurers' eagerness to take on schemes previously considered "too large to insure", indicates sustained demand for buy-outs.

However, as we have started to witness already, as volumes increase, demand will place a strain on many aspects of the buy-in process. For example, as schemes rush to market this could result in suboptimal value-minimising structuring solutions for illiquid assets, or data and benefit issues not being properly understood and corrected. On the insurer side, we have already seen glimpses of capacity crunch due to a lack of human capital. If demand becomes overwhelmingly high, we could also see some insurers having difficulty sourcing capital or assets in a short amount of time, which may push some of them to find creative alternatives.

2. New market entrants and disruptors may temper the demand

We can expect more new market entrants, bolstering capacity and increasing innovation, but placing a strain on resources and market expertise. If you look at the US market there are over 20 insurers and £2.3 trillion of Defined Benefit pension liabilities, albeit they operate in different regulatory environments. Therefore, there is scope for new market entrants for the UK market's £1.4 trillion of pension assets.

At the same time, the raft of recent UK pensions consultations are further questioning the purpose and future of pensions. With this, I am expecting increased debate on run-on in the UK pensions landscape. In addition, a public backed consolidator could become operational for small schemes. At the larger end of the market, we will see highly customised solutions creating ways to benefit from and share surplus (including but not limited to discretionary pension increases to members). However, even after you remove these schemes who may consolidate or run-on, insurers will still have the largest share of the market to go after.

3. Increased technological innovation and effiencies

As market activity intensifies and human capital constraints become more pronounced, I am anticipating advanced data analytics and generative AI technologies will automate the pre buy-in and buy-in to buy-out process.

These innovations will increase efficiency and reduce costs for both insurers and pension schemes. The trend has already started with streamlining for small and medium sized schemes. Insurers are increasingly reaching out to technology-enabled third-party specialists to fast-track data standardisation, calculation or cleansing.

Generative AI tools will have widespread use, such as Harvey AI which can turn thousands of pages of scheme rules into short succinct benefit specifications in standardised templates at the click of a button, within seconds. Technology and generative AI will not only play crucial roles in automation of administrative tasks, but will also improve customer experience e.g. using AI-driven chatbots and virtual assistants around the clock to support members. Furthermore, a future where AI algorithms can analyse market trends and economic indicators in real time to help insurers optimise investment portfolios and maximise returns may not be far away.

4. The asset game will face a few step changes

Illiquid assets have dominated the scene recently, especially with the large transactions, and they will remain an important consideration in preparing to buy-in over the next few years until such a time when the bulk of these assets get redeemed and become a smaller proportion of schemes' asset holdings. In the meantime, we will keep seeing demand for deferred premium solutions and BPA providers forming strategic partnerships with pension schemes or asset managers. Third-party investors and banks are likely to be further attracted by this market and their offering will evolve into off-the-shelf products to help finance a buy-in.

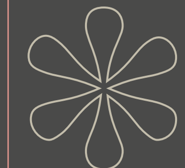
We can also expect to see a fundamental shift in the way pension schemes themselves invest, especially when planning to approach the buy-out market, recognising that an increased supply of gilts will create price matching challenges for pension schemes who have traditionally hedged interest rates and inflation using gilts.

5. Regulatory changes to adapt to market dynamics

The UK insurance market upholds the 'gold standard' of securing members' benefits, and rightly so with a robust regulatory regime safeguarding it. However, as more of the trillions of pension scheme assets transition to the insurance world, regulatory scrutiny will intensify. We have already seen a number of consultations from the PRA recently regarding Solvency UK, which aims to strike a balance between flexibility and security.

An example of the former is the launch of a new 'mobilisation' regime to allow authorisation and trading to start at an interim state of readiness, whilst an example of the latter is the PRA's June 2023 'Dear CRO' letter, as well as the November 2023 consultation on funded reinsurance aimed to reduce concentration risks. No doubt these regulatory changes will impact the dynamics of the buy-out market, potentially impacting pricing and market competition which will help shape insurer behaviour. But one thing is certain: risk transfer market activity will only be going onwards and upwards over the next decade.

Illiquid assets have dominated the scene recently, especially with the large transactions...



Chapter 3
Illiquid assets

Dweenisha Caleechurn
PwC

Dweenisha Caleechurn is a Director in PwC's Risk Transfer team, advising trustees and sponsoring employers of pension schemes. Over the last 12 years, she has worked on over £15bn of buy-ins and buy-outs, comprising some of the largest and smallest transactions in the market and including the £2.7bn Thales UK transaction with Rothesay at the end of 2023. She has also previously co-authored a paper for the Institute and Faculty of Actuaries on target end-states for Defined Benefit pension schemes.

What's to come – predictions for the future

LCP

The outlook for the buy-in/out market over the next decade is positive. We anticipate record levels of demand, met in part through a number of new market entrants, with attractive pricing opportunities persisting for well-prepared schemes.

1. Demand for buy-ins/outs projected of up to £360bn over the next five years and up to £600bn over the next decade

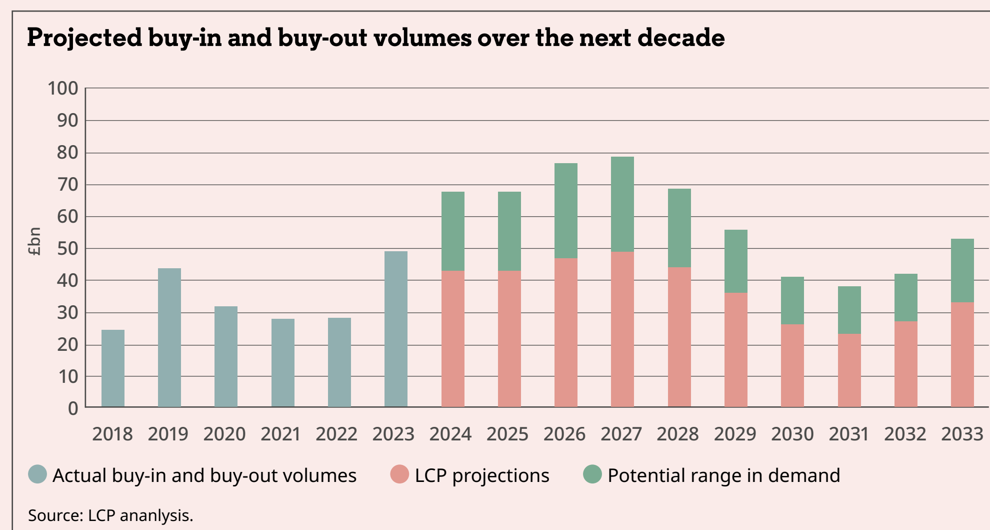
2023 saw buy-in/out market volumes of £49.1bn (or around £80bn in "2019 money"), setting a new record for the UK bulk annuity market and marking a step change from volumes of around £30bn pa for the preceding five years (with a spike in 2019).

This was driven by a greater number of £1bn+ transactions coupled with significant improvements in buy-out funding levels for many schemes over 2022, sustained through 2023, which drove record numbers of schemes to seek buy-in/out quotations. 2023 saw 12 £1bn+ transactions, exceeding the previous record of 9 in 2019 and more than double the number in 2022. This trend of more large deals looks set to continue over 2024, with insurers reporting even higher numbers of large schemes in their pipelines.

But what if we look further ahead? To assess potential demand for buy-ins and buy-outs over the next decade, LCP conducted analysis in October 2023 to project estimated buy-out funding levels into the future. From this, by making assumptions about the proportion of schemes that will seek to buy-in/out and when, we estimated how potential future demand may develop.

Our analysis (see the chart below) shows a sustained period of high demand over the five years to 2028 as many schemes reach full funding on a buy-out measure and choose to insure. Estimates of transaction volumes over the next five years of up to £360bn represent a substantial uptick from historic levels and could easily dwarf the 2023 record. The total projected volumes over the next decade are in the range c£400bn to c£600bn, with the top of the range assuming that most (but not all) schemes choose to insure over the shorter term when affordable. This is in the context of a current DB pensions universe of c£1.5 trillion.

A key uncertainty is how much of the volumes go to superfunds/consolidators instead. The long-awaited first superfund transaction by Clara in November 2023 was a key landmark, with a second deal with Debenhams announced in March 2024. However, Clara's "bridge to buy-out" model only shifts the timings, and not the ultimate destination (i.e. buy-out), of schemes transferring to them. In February 2024, the government published a consultation for a public sector consolidator run by the PPF to be launched in 2026. This could impact future demand for buy-ins/outs, depending on its entry criteria, but the policy intention is that it is aimed at schemes that are "unattractive to commercial providers" so we think this is unlikely to have a significant impact.



Source: LCP ananlysis.

2. Significant investment in the UK buy-in/out market with an influx of new entrants and capital providers over the next few years

2023 and early 2024 have seen a surge in new capital providers exploring ways of participating in the UK buy-in/out market after a period of relative stability. This is not a surprise given the predicted volumes of assets expected to transfer to insurers over the next decade. September 2023 saw M&G re-enter the buy-in market, the first market entrant in six years. Royal London followed in March 2024 (having already written two deals with their own scheme), and in April 2024 Utmost announced plans to formally enter the market later in 2024.

We are in discussions with several more potential entrants that are weighing up their options for gaining a presence in the UK buy-in/out market, including current UK insurers, overseas insurers and a range of investors. This could be through acquiring one of the 10 existing bulk annuity providers or as a new provider (noting the US bulk annuity market has 20+ providers). We have already seen Rothesay (a current provider) acquire Scottish Widows' back-book in 2024 (subject to regulatory approval).

That said, the hurdles to entry are high. The regulatory requirements under Solvency II are onerous – particularly for a provider who does not already have scale in annuities – and recruiting the necessary teams in a market that is already very tight on resources is a daunting prospect. Many potential investors are, therefore, choosing the more straightforward route of providing capital in the secondary market – through funded reinsurance and other innovative co-investing structures – rather than setting up as a direct primary insurer.

As the number of insurers increases, we need (and expect) to see greater segmentation of the UK market (as is the case in the US market), with different groups of insurers focussing on schemes of different sizes.

3. Attractive pricing opportunities will persist over the next five years driven by competitive pressures

Despite the surge in the number of schemes seeking insurer quotations, we have seen full scheme buy-in/out pricing remain attractive over 2023 and early 2024, with the pricing for smaller schemes being just as attractive as that for larger schemes. This was largely driven by competitive pressures, but there were two other helpful factors.

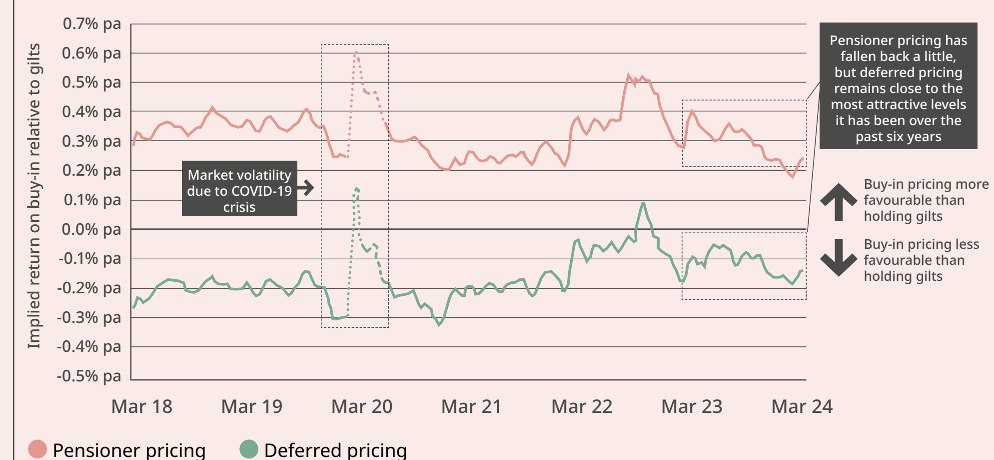
Firstly, reinsurance helped support pricing – longevity reinsurance priced in further reductions in life expectancies, and there was an expansion in the use of funded reinsurance. For example, Legal & General reported that around 25% of its record 2023 volumes were passed to funded reinsurers. The PRA has been tightening the rules on these arrangements, but we expect funded reinsurance to continue to be an important asset class supporting pricing over 2024 and beyond.

Secondly, reforms reducing the risk margin element of Solvency II have helped pricing, albeit the risk margin had already been significantly reduced due to the extensive use of longevity reinsurance plus higher interest rates. Further reforms come into effect in mid-2024 as Solvency II becomes Solvency UK; this will widen the scope of assets which insurers can use to support pricing (subject to some additional checks and balances). We do not expect these to have an immediate pricing impact (beyond that currently baked in), but over time we may see greater benefit from this change as insurers get to grips with the new rules and how to optimise their pricing.

The tightening in credit spreads over the course of 2023 and early 2024 has created some headwinds for pricing, but insurers have diversified into a wider range of assets with which to support their pricing and have continued to target schemes they have deemed to be attractive and well-prepared, driving attractive opportunities.

Looking ahead, the anticipated influx of new entrants and capital providers is expected to drive healthy competition, maintaining attractive pricing opportunities despite the strong expected levels of demand for buy-ins/outs.

Insurer pricing continues to be at attractive levels compared to holding gilts

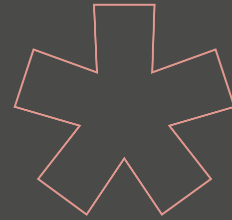


Source: LCP insurer pricing model. The model is calibrated against live quotation and final transaction pricing. Buy-in pricing depends on a wide range of factors such as transaction size, benefit structure, membership profile and insurer appetite can differ materially from that shown above.

Ruth Ward
LCP

Ruth Ward is a principal in LCP's Pension Risk Transfer team. A qualified actuary, Ruth has almost 18 years of experience in helping trustees and companies manage risk, liabilities and costs in their UK Defined Benefit pension schemes. Since 2013, Ruth has focussed on advising on pension risk transfer transactions for schemes ranging in size from under £1m to over £1bn, including both solvent and PPF+ transactions. Ruth provides regular market commentary and was the lead author of LCP's 2023 report on how to Beat the Triage and LCP's 2023 report on the buy-in/out market.

What's to come – predictions for the future



Cardano

One can lose sight of the scale of the numbers in the UK pension risk transfer market.

Around £50,000,000,000 of transactions were completed in 2023. That's equivalent to the entire GDP of many European countries. But behind the headlines, hundreds of thousands of members are getting a secure future and momentum is building behind innovation.

As we head further into 2024 and what could be another record-breaker on various fronts, we asked five of our team to make a prediction along a theme close to their heart.

How will the changing covenant of UK plc impact pension risk transfer?

We expect to see interest rates remaining well above the levels we have been used to for the last decade. This, coupled with global socio-political tensions and significant elections in the UK and beyond in 2024 means that we expect material ongoing uncertainty for companies and expect a continued uptick in company distress.

There was a time when weak corporate sponsor health would have reduced the prospect of pension schemes buying out, as funding shortfalls could not be met and businesses were focused elsewhere. But funding levels are considerably higher in 2024 and many pension schemes don't require a final contribution from their sponsoring company to top-up the premium. So, we expect concern over corporate performance to push many pension schemes more quickly towards de-risking as they crave the protection that delivers for them.

Matt Harrison
Co-Head of Cardano Advisory

How will insurance regulatory reforms impact reinsurance and asset strategies?

The UK insurance regime is currently undergoing a raft of changes. Some are confirmed such as Risk Margin reduction, with others undergoing consultation, such as funded reinsurance and reform of Matching Adjustment eligible assets.

We don't expect the changes to the Risk Margin to significantly reduce insurers' appetite for longevity reinsurance. The Risk Margin is less of a challenge in a higher-rate environment, it remains a helpful risk management tool, and reinsurers are currently putting forward competitive pricing.

We expect the use of funded reinsurance to increase given insurers' capital and asset sourcing constraints. Although, its increase is likely to be steady, and there are headwinds such as the PRA's proposals and recent changes to Bermudan insurance regulations, which could push up the cost.

Similarly, we may not see wholesale changes to insurer asset strategies, at least in the short-term. Whilst changes to Solvency UK could lead to a bigger pool of eligible assets, whether insurers have substantial appetite to take on newer assets remains to be seen, especially if senior management faces increased accountability under the PRA's new proposals.

Michael Luo
Director, Cardano Advisory

How will insurers and pension schemes innovate around illiquid assets?

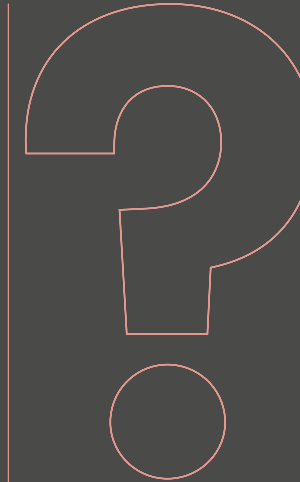
The extent to which we see innovation in solving illiquidity will depend on many factors, not least the overall volume of buy-out transactions and any changes to regulation. We expect that many pension schemes considering a transaction are starting to manage this challenge themselves to improve their marketability to insurers in an increasingly competitive market.

However, exiting some illiquid investments can be costly and difficult to enact before a transaction becomes a realistic possibility. So, insurers will need to look past this dynamic and continue to position themselves as genuine solution providers.

To do this well, a deeper understanding of the full range of illiquid asset classes is required. This could be achieved by insurers building their own specialist illiquid teams, partnering with other solution providers, or using alternative balance sheets

Chapter 3
Illiquid assets

Richard Dowell
Chief Business Officer, Cardano Investment



Will this be the year that alternative de-risking steps through the gears?

Alternative solutions were a hot topic in 2023 with Clara's recent inaugural transactions providing a much-needed boost. We expect this buzz to continue across 2024 as additional transactions potentially complete and precedents are established.

With the current high interest rate environment driving improved scheme funding and corporate sponsors' high cost of debt, capital backed solutions could also be the key to navigating corporate transactions over 2024. We expect to see the next such transaction in 2024 too albeit towards the back end of the year at the earliest.

Judy Anunda
Director, Cardano Advisory

What impact could the government have on the de-risking market?

A general election is on the horizon and all signs are pointing towards a Labour government for the first time in 14 years. Each Party has pressing priorities, both heading into and coming out of an election.

We don't think we'll be much closer to the PPF acting as a public consolidator in the next 12 months. Most of the electorate have no idea what the PPF is – which must be a good thing – and in the era of 'election winning sound bites' it may well not make the cut. We certainly welcome the member security debate in this space, and the next step is to find robust answers to the key questions that will be raised and debated as part of the recent consultation.

The government's proposal on changes to rules around when pension scheme surpluses can be repaid will undoubtedly influence endgame strategies. What will matter to many corporate sponsors' thinking is if surplus extraction is possible on an ongoing basis or only upon risk settlement. Nonetheless, these proposed changes would need to be legislated in 2024 for them to be near-term considerations, again an unlikely development given it's an election year.

Sam Norrington
Associate Director, Cardano Advisory

CHAPTER 2

SOME TOPICAL THOUGHTS

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RESIDUAL RISK INSURANCE – WHY WOULDN'T YOU PURCHASE IT?

PROTECTION

WHAT IS RESIDUAL RISK INSURANCE?

IS IT A KEY PROTECTION THAT REDUCES THE RISK OF MEMBERS NOT BEING PAID THEIR FULL BENEFITS, OR AN EXPENSIVE ADD-ON THAT DOESN'T COVER MUCH? OFTEN, THE ANSWER IS "A BIT OF BOTH".

Residual risk insurance is an extra layer of cover that can sometimes be added to a bulk annuity policy, under which the insurer assumes responsibility for members' benefits being understated. While this can be attractive to trustees and sponsors looking to give members (and themselves) extra certainty, it's critical to understand that residual risk insurance isn't cover for all risks.

Before embarking on a residual risk transaction, trustees should understand what residual risk insurance really covers, its drawbacks, and the potential alternatives.

WHAT DOES IT (AND DOESN'T IT) COVER?

IT'S OFTEN EASIER TO START WITH WHAT RESIDUAL RISK INSURANCE DOESN'T COVER.

This will vary from transaction to transaction, but any liabilities other than the payment of the correct benefits (e.g. costs incurred in dealing with or defending a claim, fines or penalties) and known issues will almost invariably be excluded.

These exclusions will still need to be addressed using an alternative or supplementary solution, which can sometimes leave trustees questioning what they are paying for.

The real protection offered by residual risk cover is against unknown unknowns; not the issues that can be uncovered through legal and data due diligence, but the overlooked beneficiaries, the forgotten special benefit promises, the unexpected change in law. It also (generally) has the advantage of not being subject to any liability cap, or time limits for claims.

The value of this protection will depend on the size and age of the scheme, the complexity of the benefit structure and its history, and the quality of the scheme's data and record keeping.

WHAT ARE THE DRAWBACKS?

IN ADDITION TO THE KEY POINT, THAT RESIDUAL RISK INSURANCE IS UNLIKELY TO BE A COMPREHENSIVE SOLUTION, THERE ARE SOME OTHER DRAWBACKS OF WHICH TRUSTEES AND SPONSORS SHOULD BE AWARE.

Cost. Additional protection comes at a price, generally in the region of an extra 0.5%-1% on the buy-in premium. As it's uncertain at the point of purchase whether any issues will materialise, it can be difficult to assess whether this represents good value for money.

Time/resource. Insurers assess how much additional risk they are taking on by undertaking extensive due diligence on a scheme's data, legal documents and administrative processes. This will require significant input from the trustee, scheme administrator and advisers, and can add significantly to the timeline for completing the transaction.

Insurer appetite. The due diligence exercise also has a significant impact on insurer resource and capacity. This, combined with the uncertain liability an insurer takes on under residual risk insurance, means not all insurers are willing to provide it (and those which are may only be willing to offer it on larger transactions). A request for residual risk insurance may therefore result in fewer insurers being willing to quote, leaving trustees with decreased competitive tension and fewer options.

Uncovering issues. Many trustees will undertake their own due diligence ahead of approaching the market for a buy-in, but even where this is the case, there remains the potential for the insurer's investigations to uncover issues in the scheme's data or benefits which need fixing prior to buy-out. While this has the advantage of increasing the likelihood that members get paid the right benefits, it can have a consequential cost and timing impact on the overall transaction.

WHAT ARE THE ALTERNATIVES?

THERE ARE A NUMBER OF SOLUTIONS WHICH COULD BE USED AS ALTERNATIVES TO RESIDUAL RISK INSURANCE, AS WELL AS PART OF A PACKAGE OF PROTECTIONS THAT INCLUDES IT.

Preparation. Many potential benefit issues can be identified ahead of buy-out (providing greater certainty that members are being bought out with the correct benefits) by thorough preparation. A comprehensive review of scheme data and legal documents can often give trustees and sponsors a high degree of certainty that the benefits being insured under the bulk annuity policy are correct.

Employer indemnity. Most trustees will look to secure an indemnity from the scheme sponsor that continues after buy-out, to protect against future claims. Where the sponsor has a strong covenant, this can be an invaluable form of protection against the risk of bought out benefits being incorrect (particularly if the sponsor is willing to grant third party rights that enable members to bring claims directly).

Run-off cover. This is a form of pension trustee liability insurance (which many trustees will benefit from while a scheme is ongoing) which continues after buy-out. It can provide protection against maladministration claims, civil fines and penalties, missing beneficiary claims and the costs of defending claims (even when they are unsubstantiated). Run-off cover is typically cheaper than residual risk insurance, but usually lasts only for a limited term and is usually subject to a liability cap.

Standalone residual risk cover. In some cases, it may be possible to insure a scheme's residual risks through the general insurance market. This route could offer many of the advantages of residual risk insurance provided by a bulk annuity insurer, together with the ability to tailor scope, term duration and liability caps on a transaction by transaction basis, but it remains relatively untested in the market.

SO, WHY WOULDN'T YOU PURCHASE RESIDUAL RISK INSURANCE?

RESIDUAL RISK INSURANCE MAY NOT BE THE RIGHT SOLUTION IN THE CONTEXT OF TRANSACTIONS WHERE PRICE OR SPEED IS KEY, AS FEWER INSURERS ARE LIKELY TO QUOTE ON THE TRANSACTION, AND THE INSURER-SIDE DUE DILIGENCE PROCESS CAN ADD SIGNIFICANTLY TO THE TIMELINE (PARTICULARLY IF NEW ISSUES ARE IDENTIFIED).

Trustees and sponsors may also find that with thorough preparation, schemes with strong sponsors willing to provide practically useful indemnities may be able to manage residual risks outside the context of a bulk annuity transaction.

We would always encourage trustees to think about residual risk management early in their endgame planning process, and consider carefully which solution best fits the priorities and risk profile of each particular scheme – residual risk insurance may not be the only answer.

Rosamund Wood
Eversheds Sutherland

Ros is a partner in the Eversheds Sutherland pensions team, specialising in risk transfer transactions. She advises all key stakeholders on the full range of risk transfer solutions including bulk annuities, longevity swaps, funded and longevity reinsurance, capital backed journey plans and captive (re)insurance structures. Ros has particular experience advising trustees, sponsors and insurers on residual risk transactions, and advised Rothesay on the £1.4bn residual risk buy-in of the Rexam Pension Plan in 2023.

Harriet Burchett
Eversheds Sutherland

Harriet is an associate in Eversheds Sutherland's pensions team and advises insurers, reinsurers, trustees and sponsors on all aspects of pensions law, including advising on a range of risk transfer transactions and de-risking solutions. Harriet works with the wider Eversheds Sutherland risk transfer team to help deliver complex and high value buy-in transactions, including conducting due diligence for residual risk insurance.

RESIDUAL RISK – RUNNING A SUCCESSFUL DUE DILIGENCE PROCESS

DD

Before an insurer finalises its premium and sets its terms for residual risk cover, it will want to undertake its own due diligence ("DD") on the scheme. The DD involved in a residual risk transaction is a significant and intensive undertaking for all involved. In some cases, our pricing team spend at least as many hours on residual risk DD as the rest of the transaction put together (if not more!) – and the same can be said for some of the advisers too. So, if you do decide to purchase residual risk cover, it is important not to underestimate the positive impact of a smooth and efficient DD process for all involved.

THERE ARE TWO MAIN ASPECTS TO RESIDUAL RISK DD – LEGAL AND DATA, AND THEY ARE BOTH JUST AS IMPORTANT AS EACH OTHER.

TIMING

WHEN THINKING ABOUT THE TIMING OF A RESIDUAL RISK DD PROCESS YOU SHOULD START BY MAPPING OUT THE WHOLE MARKET PROCESS: FROM PREPARATION, TO APPROACHING INSURERS, TO TARGETING INCEPTION OF THE POLICY.

Often the insurer's DD process takes place during exclusivity, once you have chosen your preferred insurer, and they will expect the documents and data to be available immediately from that point. There will be a limited time window for the DD to take place (usually a number of weeks) – so make sure you are ready to hit the ground running when the clock starts ticking.

When mapping out the process, you should also have in mind the structure and scope of residual risk coverage that you are seeking – will you be asking the insurer to be on-risk from the outset, or from after the data cleanse/at buy-out? Are there any known issues you want to be included in the cover, and equally are there areas you'd prefer to be excluded? Minor differences in the scope of the cover can lead to big differences in the approach an insurer will take, and it can be challenging to change structure later down the line.

BEFORE THE INSURER DD BEGINS...

TRUSTEES SHOULD MAKE SURE THEY'VE BUILT IN TIME TO CARRY OUT THEIR OWN DD BEFOREHAND.

Ideally this would include producing a legally signed-off benefit specification, and identifying areas where the administration practice does not align with the scheme rules - this will give early attention to known issues. When you are comparing, all parties involved in the operation of the scheme should contribute – lawyers, administrators, the scheme actuary, and anyone else with scheme specific knowledge (e.g. a knowledgable pensions manager, scheme secretary and the company representatives). It is often the case that the most material findings of DD are already things that are known about, or could have been known about, by someone within the wider scheme advisory team before the insurer DD has started. Identifying these types of issues in advance ensures a clear picture for insurers as you go to market and provides more execution certainty.

WHAT ABOUT THIRD-PARTY LEGAL DD REPORTS?

Prior to approaching the market, some trustees appoint a lawyer to conduct legal DD on the scheme on their behalf (a 'seller's report'), maybe then offering reliance to insurers for their DD. Another variation is the 'buyer's report', where the legal DD is carried out on the insurer's behalf (as opposed to the trustees'). Seller's and buyer's reports are certainly helpful to insurers - in particular, it gives us comfort that the transaction is viable if the trustees have already considered the cost implications of big issues which have already come to light. In addition – having the legal DD carried out up front means we know exactly what benefits we are conducting our checks against in the data DD. However, insurers might have different views to trustees on the scope of a particular issue, and the associated risks – at Rothesay we will always still conduct our own DD (potentially as a 'top-up' to the DD that has already been done).

DATA ROOM

MAKE SURE YOUR DATA ROOM HAS BEEN POPULATED WITH AS MUCH INFORMATION AS POSSIBLE.

Each insurer will have their own requirements, but as a minimum all insurers will need a complete set of legal documents from throughout the scheme's history.

BEING PROACTIVE CAN SAVE TIME

For the data DD, there is a large volume of information to transfer to us (including full administration database extract, payroll files, comments on member files, image files on the system). Think about what is actually used in the day-to-day running of the scheme. What information will we ultimately need to pay the scheme's benefits? If there is a complicated underpin – have we been provided with the underlying data to support this in practice? Is this data in electronic form? Is there a separate spreadsheet of data not loaded in the system which gets used regularly? Are there paper files which regularly get rifled through? Are there any known issues that have already come to light? The administration team will have a good sense of where the data is in decent shape, and where there are gaps. Being proactive can save a lot of time if providing something early on prevents queries from arising later down the line, and particularly if it can limit the number of data cleanse actions we require the scheme to complete.

EASY WINS

Often overlooked, but there are some easy wins to be had when setting up your data room, particularly when there is a limited time window for insurers to conduct their DD. Can we bulk download the many hundreds (or thousands) of files in one go? Is the data room well indexed and structured, can we easily figure out what the files are? Is there enough space on the data site to cope with those large member image files? If not, how will this information be shared? Are any of the files password protected, will this cause issues once downloaded? Are the file names too long, will this cause an error once downloaded? Are there any paper files, how will these be shared? What are the information security considerations?

These simple issues can all take time to work through if they crop up, and it's much better to have a workable setup from the outset (including a shared understanding of how files should be uploaded) so that time spent during the limited DD window is focused on the residual risk issues themselves rather than basic practicalities.

QUERY LOGS

INSURERS WILL BE THOROUGH IN THEIR DD AS THEY WILL WANT TO FIND OUT AS MUCH ABOUT THE SCHEME AS THEY CAN.

This means that they will ask questions of the scheme's advisers and administrators. Question volumes may be quite high, especially for larger schemes, and you should be prepared for this. As trustees, whilst you don't want the day to day running of the scheme to be disrupted, the responses to these questions will have an impact on which items are covered (or not) by the residual risk cover you are purchasing, and the cost. So, it's important to make sure you've got enough resource lined up and available to cope with responding to queries.

- **Be engaged:** The level of engagement when responding to queries will influence the outcome when we determine which issues need to be excluded from the residual risk cover, and which items we need the scheme to carry out data cleansing on (particularly if things are unclear), so good engagement and accurate responses can lead to a better outcome for the scheme. Prep your administration team and take them on the journey with you, as they will be key to a successful process.
- **Who should respond:** There will be separate query logs running for the legal DD and the data DD. It will be key to the process to work out who the right people are to respond to queries, and to know what their availability is like during the DD window (be aware of and plan around any holidays).
- **Be upfront:** Open and honest responses are always best. We don't mind if we find issues, in fact we expect to find issues – if we find something which isn't perfect it means we are doing our jobs properly. If the administrator is unsure of how to respond to a query, rather than sitting on it and moving it down the priority list, we would much rather discuss any concerns up front and work through the issue. If a piece of data is missing, it is OK for the response to be 'the records don't exist' - we'd much rather know this quickly and identify the issue up front, rather than everyone spending a long time looking into something which ultimately can't be explained.
- **Proportionate process:** Consider your governance process for query responses and try to keep it from becoming too onerous. The process should be proportionate with the query - not all queries will need to go through multiple layers of review if they are quick and easy. This can be an area to save time to spend on the trickier issues.

MEETING THE ADMINISTRATOR

To further the understanding of the scheme's history and processes, insurers may want to meet the key team members from the scheme's administrator face to face on-site - they often know the scheme and its data best. It is often useful to see how the administration team accesses the information, and how it appears in their systems.

REMOTE vs ON-SITE DD

THERE ARE TWO WAYS IN WHICH INSURERS CAN CARRY OUT THEIR CHECKS – EITHER ON-SITE, OR REMOTELY.

There are pros and cons to both. On-site DD has the potential to be disruptive to the administration team, although the disruption can be minimised if insurers can gain read-only access on-site (which means they can be self-sufficient without someone from the administration team needing to "drive" the system). Make sure there are enough terminals available for the insurer to use, and that there is adequate time for the insurer to complete their checks. Alternatively, conducting DD remotely allows the insurer to operate in their own office. It is worth bearing in mind that someone from the administration team will need to pull together the required information at the outset and send this securely to the insurer. In particular, image files can be quite sizable and time consuming to transfer.

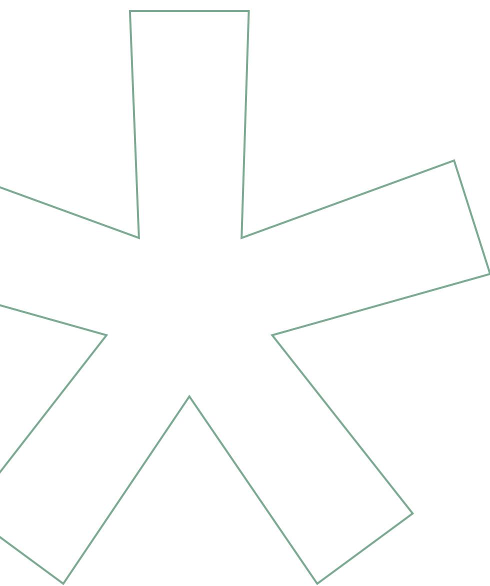
TO CONCLUDE

WITH SO MANY STAKEHOLDERS INVOLVED, GOOD MANAGEMENT OF THE PROCESS IS KEY – WE WANT TO WORK WITH THE ADMINISTRATORS AND ADVISERS COLLABORATIVELY TO HELP THE PROCESS RUN SMOOTHLY FOR EVERYONE. OF COURSE, THE PRACTICALITIES NEED TO BE CONSIDERED ON A CASE-BY-CASE BASIS BASED ON WHAT IS PRAGMATIC, REALISTIC AND ACHIEVABLE.

Katie Overton
Rothesay

Katie joined Rothesay's Business Development team in 2021 and has worked on transactions with the pension schemes of Morrisons, Safeway and Smith & Nephew. Prior to joining Rothesay, Katie worked in pensions consulting at WTW for 10 years, advising trustees and sponsors in relation to their DB pension schemes. Katie is a Fellow of the Institute and Faculty of Actuaries and has received the Chartered Enterprise Risk Actuary accreditation.

61 | Rothesay | The journey to buy-out 2024
Welcome to the endgame
Chapter 2
Some topical thoughts



THE RISE OF THE PROFESSIONAL TRUSTEE

OVER RECENT YEARS, WE'VE SEEN A SHARP RISE IN THE NUMBER OF PENSION SCHEMES APPOINTING A PROFESSIONAL TRUSTEE, WITH THIS ONLY EXPECTED TO INCREASE GOING FORWARDS. WITH THAT IN MIND, IN THE FOLLOWING ARTICLE TOM ASHWORTH LOOKS AT THE BENEFITS OF HAVING A PROFESSIONAL TRUSTEE ON BOARD.

Tom Ashworth
WTW

Tom is a Director in WTW's Transactions Team, with ten years of experience in this space. He has led the advice on a wide range of bulk annuities, a recent highlight including the first deal for a new market entrant in 2023.

RUNNING A PENSION SCHEME IS A COMPLICATED BUSINESS, AND IT'S FAIR TO SAY IN RECENT YEARS THIS ROLE HAS BECOME MORE INVOLVED.

In WTW's latest Trustee Governance survey, when asked about the evolving role of a trustee, 3 in 4 responded to say their role had become more difficult with 80%+ believing that the role carries significantly more risk than previously.

With the challenges this brings, it's not hard to see why, alongside their advisers, schemes are turning to professional trustees to meet these increasing demands.

SO WHAT DOES A PROFESSIONAL TRUSTEE BRING TO THE TABLE? I'VE WORKED WITH LOTS OF EXCELLENT PROFESSIONAL TRUSTEES OVER THE YEARS AND IN MY EXPERIENCE KEY BENEFITS INCLUDE:

Specific expertise: A professional trustee will often have a deep background in the pensions industry, being able to share this and bring it to life in board meetings. Professional trustees are often chosen for their specific skill set, be that investment, legal, actuarial, governance or a whole host of other backgrounds to help supplement the board in a particular area.

Market experience: As professional trustees work across a range of pension schemes as their "day job", this gives greater exposure to the pensions landscape to draw upon. This can provide a bank of experience and alternative viewpoints to share alongside scheme advisers to a board who may need to get their head round the problem for the first, and potentially only, time.

Governance efficiencies: Professional trustees can improve governance and provide valuable resource for a scheme, easing the burden on the wider trustee board. This can help maintain momentum for projects between meetings, allowing practical tasks to progress more quickly, while the wider trustee board focuses on key strategic decisions. For example, being the "go-to" person for signatures or as point of contact for other parties, such as the sponsor, in the first instance.

Diversity: Looking outside of scheme members and the sponsor can help bring a greater diversity to a trustee board, fostering healthy challenge and debate through diversity of thought. When selecting a professional trustee, one key area to consider is how the individual will fit in culturally with the existing trustee board, including working manner and communication style.

Independence: The independence brought by a professional trustee can help to manage potential conflicts, for example when discussing use of surplus or considering discretions. Here, where a member or company nominated trustee may find themselves in a more conflicted position, the professional trustee may be able to take a more neutral position to assess the options.

DOES THIS SOUND TOO GOOD TO BE TRUE?

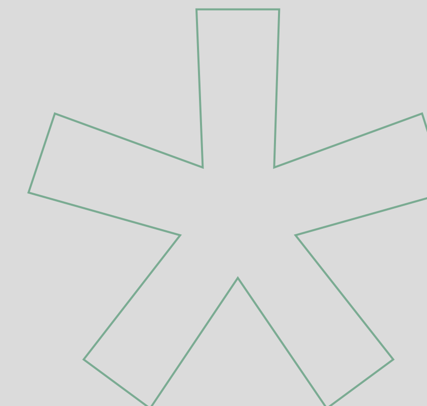
Personally, I'm a big believer in the value that professional trustees bring to trustee boards, but of course there are some potential drawbacks to be aware of. For example, there may be a perception of a conflict of interest where the professional trustee is appointed and paid via the scheme sponsor. However, experienced professional trustees are very aware of this and experienced in managing it, with a professional fiduciary duty to act in the best interests of members. It's also important that a professional trustee uses their experience to enhance trustee discussions, challenge advisers and generate debate from the full trustee board. This way, a collective decision can be reached by the board, rather than leaning too heavily on the professional trustee's opinion.

AS SET OUT ELSEWHERE IN THIS REPORT, MORE AND MORE SCHEMES ARE CONTEMPLATING BUY-OUT OVER THE COMING YEARS.

In my experience, having a professional trustee on board can be particularly beneficial during a buy-out project. For example:

- A professional trustee can provide invaluable guidance and comfort to the wider trustee board, many of whom will never have gone through a buy-out project before.
- In a similar way to insurers favouring transactions where the trustee has appointed experienced advisers with a proven track record, insurers view the presence of an experienced professional trustee positively when deciding which cases to quote on.
- The professional trustee can help the wider trustee board to manage the increased workload that comes with a buy-out project. This can include chairing a working group and helping to maintain momentum between meetings, where more regular decisions are required than the usual trustee meeting cycle allows.
- In periods of market volatility and potential opportunities, for example at the time of the COVID-19 outbreak, or the 2022 Mini Budget, those schemes that were the most 'fleet of foot' were much better positioned to avoid pitfalls or take advantage of such opportunities. Any actions, including appointing a professional trustee, that could provide governance efficiencies can provide real value here, where even a day or two swifter decision making could lead to a difference of £millions.
- I've seen professional trustees provide real value in driving the scheme forward post buy-in. A number of workstreams at this stage are process driven, and having a focussed professional trustee with experience of working through these and the time to dedicate to the project can help accelerate overall timing to buy-out (while avoiding the need to fully train lay trustees for a process they will likely only participate in once).

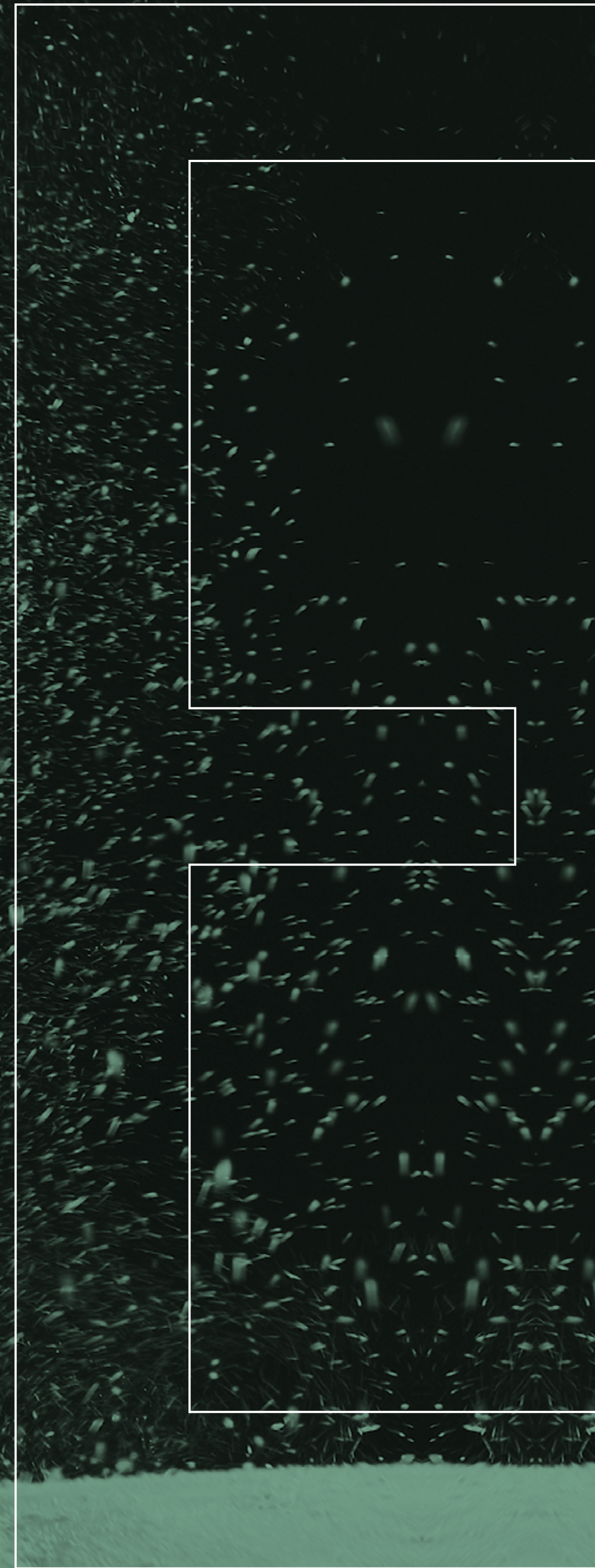
OVERALL, THE KEY THING IS...

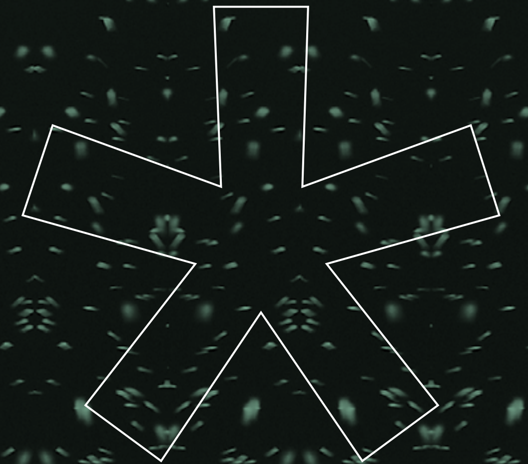


that any trustee board regularly assesses whether it has the right level of skill, experience and time to run their pension scheme effectively. Many pension schemes do, and will continue to, operate effectively without a Professional Trustee.

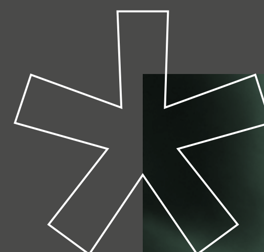
At a time where the role of trustees is becoming more challenging however, bringing in an experienced professional can add real value to fellow trustees, the scheme sponsor and most importantly scheme members.

FUNDED





RGA



FUNDED REINSURANCE

HOW DOES REINSURANCE FIT IN TO THE JOURNEY TO BUY-OUT?

As more and more companies look to secure member benefits and remove legacy defined-benefit pension schemes from their balance sheets, the question of how to distribute the built-in risk to give the greatest security for members remains. The security that insurance companies can offer to trustees and members is enhanced by their use of reinsurance. Insurers can focus on the ideal customer and trustee experience, while reinsurers can work to diversify their risk exposure across liabilities and geographies, and hence place themselves as the ideal vehicle for risk protection.

The primary reasons for insurers to use reinsurance are to:

1. Reduce their amount of risk, thereby limiting volatility from claims, strengthening their balance sheet and increasing security for policyholders.

2. Reduce the amount of capital required to protect against risk, creating potential opportunities to offer more competitive pricing to trustees and policyholders.

While the industry is familiar with the traditional longevity swap reinsurance protection, insurers are increasingly using complementary funded reinsurance. Use of this risk protection can create a win for all parties involved: the reinsurer, the insurer, the trustee, and the members themselves.

WHAT IS FUNDED REINSURANCE?

Funded reinsurance of bulk annuity transactions can be explained most simply as a collateralised buy-in between an insurer and a reinsurer. After entering a bulk annuity contract with a pension scheme, the insurer enters a separate reinsurance agreement to cover all, or part, of member benefits. The insurer pays a single premium to the reinsurer, at which point the reinsurer assumes responsibility for the cost of pension benefits, which it pays to the insurer to be distributed to the trustee or the members.

With a longevity swap, the insurer retains the assets and uses these to pay the 'expected' benefits and fee to the reinsurer, in exchange for the reinsurer paying the 'actual' benefits. Because the expected amounts transferred net off, there is no up-front payment of premium. With funded reinsurance, the reinsurer essentially takes the payment of the expected benefits from the insurer up front as a fixed premium in return for paying the future reinsurance benefits. The added benefit for the insurer is that funded reinsurance also provides protection against the risk that assets do not perform as well as expected.

It is important to note that funded reinsurance is typically structured so that assets are collateralised and held within the UK, a priority consideration for both insurers and regulators. With the right reinsurance partner, insurers receive the backing of a well-rated, highly diversified and credible partner – with assets readily available in the unlikely event of a failure of the reinsurer. Meanwhile, regulators can rest assured that investment in UK infrastructure and assets will not move offshore.

WHY IS IT USED? WHO BENEFITS FROM IT?

Insurance companies tend to use funded reinsurance when the bulk annuity market is busy, and when very large transactions come to market. In both scenarios funded reinsurance can help to manage lumpy capital requirements and assist with operational restrictions around asset sourcing. From the reinsurer's perspective, as a non-correlated risk, asset risk only further diversifies the balance sheet in the case of a multi-line, global, life reinsurer.

For the trustee, the insurer passing on asset risk might be counterintuitive, but the use of funded reinsurance can mean that:

- There is greater competition, and better pricing can be offered to the scheme.
- The industry can continue to provide buy-out cover for smaller schemes when multi-billion schemes come to market.
- The insurer has support from a well rated, highly diversified and credible partner.

Furthermore, member security improves with a diversified global reinsurer sitting behind the insurance company, which might be much more exposed to volatility within a few geographies or business lines.

At RGA we have offered funded reinsurance globally for nearly two decades and in the current economic climate, which has triggered a very active bulk annuity market, we are seeing an increase in UK bulk annuity providers selectively turning to this proven risk protection cover. We know first-hand that the right arrangement can create a win-win for all involved.

WE KNOW FIRST-HAND THAT THE RIGHT ARRANGEMENT CAN CREATE A WIN-WIN FOR ALL INVOLVED.

Danielle Harrington
Reinsurance Group of America, Incorporated (RGA)

Danielle Harrington is VP, Head of Strategy & Operations, Europe at RGA. Danielle joined RGA in 2013, where she is responsible for the structuring and execution of EMEA longevity, capital motivated, and funded reinsurance transactions. Prior to her joining her current team in 2015, she worked as a Pricing Actuary at RGA, where she was responsible for pricing reinsurance UK protection products. Before joining RGA, Danielle was a Pricing Actuary at Lucida plc where she priced and executed BPA transactions with UK pension schemes. She is a Fellow of the Institute of Actuaries.

ROTHESAY

ROTHESAY'S WIDER REINSURANCE STRATEGY

At Rothesay we have used traditional longevity ("unfunded") reinsurance since our inception, principally as we believe it is a sound risk management practice. As at the end of 2023, we have in-force longevity treaties and strong ongoing relationships with 14 reinsurers, which includes all those actively quoting in the UK pension risk transfer space. Our motivations behind ceding longevity risk to the global reinsurance market are broadly unchanged over the years, namely:

- In a longevity swap, variable (longevity-risky) cashflows are exchanged with fixed cashflows, and as such longevity reinsurance directionally stabilises several key metrics – including capital coverage and annual earnings.
- The cost of reinsuring longevity risk is often more efficient compared to the cost of capital a UK monoline insurer would have to set aside to cover the risk. This is because reinsurers are well-diversified risk carriers with many other non-correlated risks (i.e. non-life risks), and the longevity risk they are taking on offsets their mortality risk from life insurance policies. As such, longevity reinsurance improves our solvency position, making our capital position more efficient, and ultimately enabling us to offer more attractive pricing to our trustee clients.
- In situations where the longevity reinsurance is placed concurrently with the bulk annuity transaction, we can avail ourselves of the considerable technical underwriting expertise of the reinsurance market, supplementing our in-house experts.
- Rothesay target a certain overall risk profile, i.e. a given combination of asset risk, longevity risk, liquidity risk, credit risk, market risk etc.; reinsurance is a highly effective risk management tool at our disposal which allows us to rebalance the risk profile of our overall book.

By contrast, within a funded reinsurance transaction, both longevity and asset risk are transferred. The benefits of traditional longevity reinsurance listed in the first three bullet points above apply equally to funded reinsurance, but the dynamic of the last bullet is different: with funded reinsurance, there is effectively a transformation of asset risk, longevity risk, market risk and liquidity risk into solely credit risk (i.e. the risk of the funded reinsurance partner defaulting on their obligations).

ROTHESAY'S PERSPECTIVE ON FUNDED REINSURANCE

Whilst we have engaged with various reinsurers who offer funded reinsurance, we have not yet found a package that works for us – and we do not believe funded reinsurance will form a part of our risk management strategy in the foreseeable future. Whilst we recognise the value funded reinsurance has to some of our peers, there are several reasons why it is less attractive to us:

1. Rothesay has significant expertise and experience in asset sourcing, and we have used a largely "in-house" model since our inception. Our asset origination team have a deep understanding of the specific Solvency II requirements we are subject to, and are well integrated with our credit monitoring, liquidity and capital teams.

In our view, bringing a third party asset sourcing/management provider into this system would introduce inefficiencies and reduce our ability to react quickly to market events.

2. We are fortunate to benefit from a strong capital base, with two supportive long-term shareholders. Given this, we have not required significant external capital to back our new business activities.
3. The reinsurers offering funded treaties generally fall into two camps:
   i. "traditional" reinsurers who have operated in the UK bulk annuity space for many years, and
   ii. new entrants who are generally interested in taking asset risk only (i.e. they would look to "retrocede" any longevity risk).

Facing either of these camps of reinsurers comes with its own challenges:

- Our counterparty limits apply on an aggregated by-entity level, and as such entering into a funded reinsurance transaction with any of the traditional players would eat into our overall limits and hence our ability to place regular unfunded longevity swaps with those counterparties.
- The non-traditional reinsurers will often have an overall risk profile which looks quite similar to Rothesay's (i.e. generally more heavily weighted towards asset risk), which is at odds with our risk management objective to cede risk to multi-line, well diversified reinsurers.

4. One of the main reasons we don't use funded reinsurance is because the terms of the collateral package do not give us the protections we need to fit within our risk appetite. For example, they include unfavourable dispute terms, infrequent margining, and lower than standard haircuts.

HOW DOES ROTHESAY EXPECT THE FUNDED REINSURANCE MARKET TO DEVELOP?

We believe that our approach to funded reinsurance makes us somewhat of an outlier in the UK bulk annuity market, and that most of our peers will continue to use funded reinsurance to some extent as part of their wider reinsurance strategy. The UK bulk annuity market is likely to continue to see growth in annual total volumes as well as maximum individual deal sizes, and funded reinsurance will likely have a role to play in providing both external capital and asset sourcing capabilities.

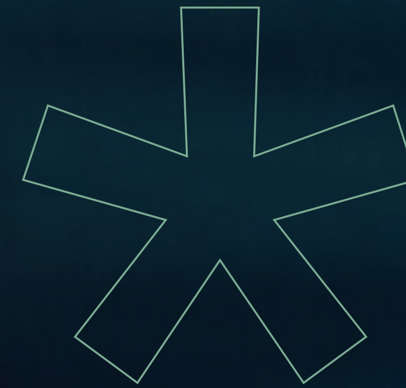
We note there is an ongoing PRA consultation paper on usage and treatment of funded reinsurance by UK insurers, and we will be contributing towards this lively debate in the interests of the wider stability and health of the UK bulk annuity insurance market.

Ben Howe
Rothesay

Ben Howe is Head of Reinsurance at Rothesay. Having joined Rothesay in 2014, he is now responsible for the negotiation and execution of longevity reinsurance transactions, and for the ongoing management of the growing back-book of reinsurance treaties. Ben is part of the wider new business team and has been involved in most of the liability and reinsurance transactions Rothesay has entered into in the last 10 years. Prior to joining Rothesay, Ben worked as a consultant at EY. He is a Fellow of the Institute of Actuaries.

DEEP DIVE

INTO SOLVENCY UK

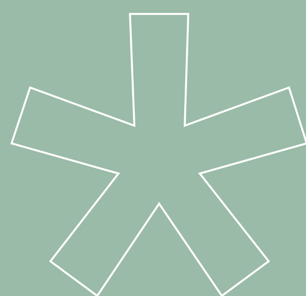


BACKGROUND

IMPLEMENTED ON 1 JANUARY 2016, SOLVENCY II IS THE RISK-BASED PRUDENTIAL REGULATORY REGIME FOR INSURERS AND REINSURERS IN EUROPE. IT IS A HIGHLY PRUDENT, GOLD-STANDARD REGIME – THE ASSOCIATION OF BRITISH INSURERS (ABI) HAS CONSISTENTLY RECOGNISED IT AS BROADLY FIT FOR PURPOSE, ALTHOUGH IN NEED OF CERTAIN REFINEMENTS.

DEEP DIVE

INTO SOLVENCY UK



With the United Kingdom's withdrawal from the European Union, the government and the Prudential Regulation Authority (PRA) saw the opportunity to refine Solvency II to better reflect the unique nature of the UK insurance sector. In 2020, HM Treasury launched a review[1] of Solvency II with three objectives – around competitiveness, policyholder protection, and incentivising UK insurers to invest in long-term productive finance.

The outcome of the government's review is the new Solvency UK regime, which is expected to be implemented in full on 31 December 2024. Solvency UK will be broadly similar to Solvency II, although it will be largely set out in the PRA Rulebook rather than in legislation. The main areas of initial change will be in the calculation of Technical Provisions – in particular the Risk Margin and the Matching Adjustment. More details on these two elements of the regime are set out opposite.

RISK MARGIN

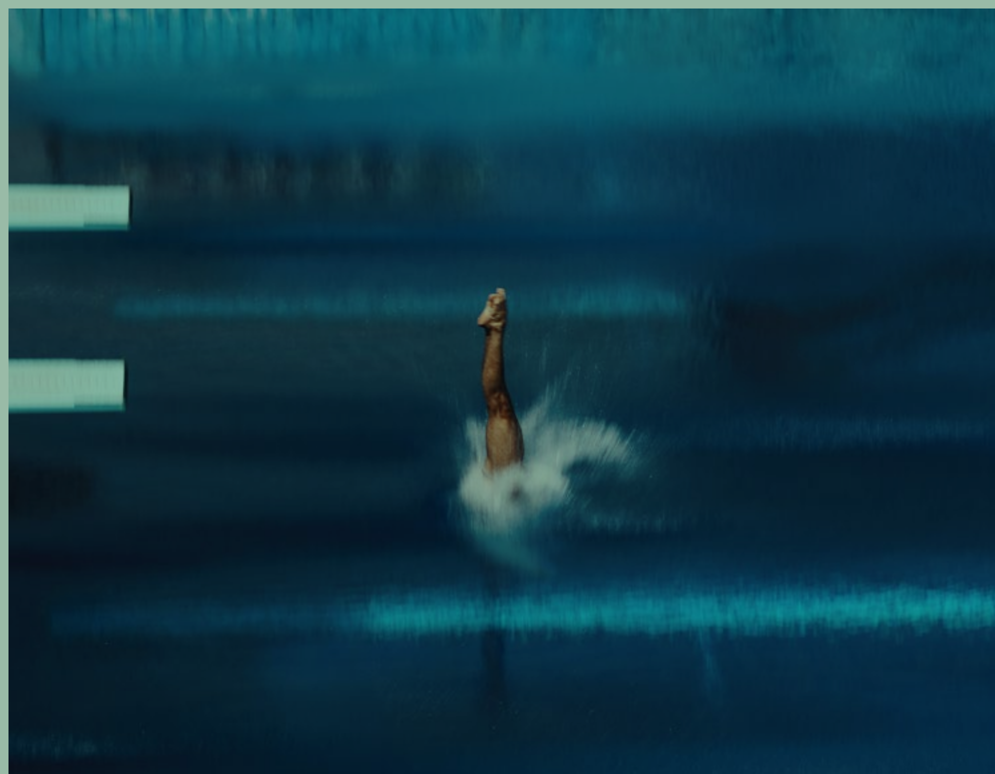
The Risk Margin is an additional buffer within Technical Provisions, intended to ensure that funds are available to transfer the liabilities of a failing insurer to a third party with no detriment to policyholders. It is calculated as the product of a Cost of Capital (CoC) rate and the sum of future Solvency Capital Requirements (SCRs) for non-hedgeable risks (discounted at the risk-free rate).

While it is generally accepted that the Risk Margin performs an important function, and few now would call for its removal, its calibration during the early years of Solvency II was not fit for purpose – it was too large, too sensitive to interest rates and inappropriate for long-term business in particular. The PRA itself described the Risk Margin calculation as "simply wrong".[2]

Considerable effort has been devoted to developing an alternative methodology and calibration for the Risk Margin. This work culminated in a revised Risk Margin formula[3] for the UK, implemented on 31 December 2023. This includes a reduced CoC rate and a new 'risk tapering factor' (lambda) applied to the SCRs, reflecting the non-independence of future risks.

The new formula is expected to reduce the Risk Margin for life insurance business by c65%, and for non-life insurance business by c30%.

1 HM Treasury Review of Solvency II: Call for Evidence October 2020
2 Treasury Committee Oral Evidence The work of the Prudential Regulation Authority 16 January 2018
3 Statutory Instrument 2023 No. 1346 The Insurance and Reinsurance Undertakings (Prudential Requirements) (Risk Margin) Regulations 2023 8 December 2023



MATCHING ADJUSTMENT

The Solvency II Matching Adjustment (MA) is an addition to the risk-free discount rate used by insurers to value their liabilities. It recognises that long-term, 'buy and hold' insurers are not exposed to day-to-day fluctuations in the market value of the assets used to back those liabilities. It is calculated by subtracting the Fundamental Spread (an allowance for risks retained by the insurer) from the asset spread over risk-free.

It is difficult to overstate the importance of the MA. The PRA calculated[4] that at year-end 2022, it was worth c£66 billion in aggregate to UK annuity insurers. It is an element of the regime that works as intended – smoothing the path through market dislocations, such as when credit spreads spiked during the early days of the COVID-19 pandemic.

The MA has general support throughout industry, the regulator and the government. The PRA has consistently expressed its support, stating that "properly implemented, it does appropriately reflect the risks to which annuity writers are exposed".[5] Nevertheless, over the years the PRA has also expressed concerns about the use of the MA. It has noted[6] that the assets held in MA portfolios have changed over time, and are no longer just the vanilla corporate bonds for which the MA was originally designed. Since Solvency II implementation, we have seen detailed policies from the PRA setting out its expectations regarding the MA treatment of assets such as equity release (lifetime) mortgage loans[7,8] and real estate loans[9].

In early 2023, three PRA-industry subject expert groups (SEGs) were set up to look at three separate strands of the MA framework, on investment flexibility (increasing the universe of assets eligible for the MA), attestation (a new requirement for senior managers to confirm the sufficiency of the Fundamental Spread and the quality of the resulting MA) and notching (increasing the granularity of the Fundamental Spread calculation).

The fruit of the work of the SEGs was the PRA's September 2023 consultation paper[10] on reform of the Matching Adjustment, which proposed a new framework for implementation on 30 June 2024. The ABI's view was that this was a positive first step in the right direction from the PRA. The consultation contained much that was good – such as expanding the universe of assets and liabilities eligible for MA treatment, removing the sub-investment grade 'cap', and setting out a much less punitive process for dealing with breaches of MA compliance. It also left the calculation of the Fundamental Spread largely unchanged, as directed by the government[11] – there will be no dependence on current spreads.

However, there are some significant challenges ahead on how to make the reformed regime work in practice – the PRA has proposed a large number of additional regulatory requirements. Insurers holding assets with 'highly predictable' (rather than absolutely fixed) cash flows in their MA portfolios will be required to apply a minimum addition to the Fundamental Spread, will be limited in terms of the proportion of the MA benefit that can be derived from such assets within each MA portfolio, and will be required to apply new cash flow matching tests. The ABI has urged the PRA to engage with the industry to seek ways to ease these new requirements as all stakeholders become more comfortable with the new framework.

4 PRA consultation paper CP19/23 Review of Solvency II: Reform of the Matching Adjustment 28 September 2023
5 PRA speech An Annuity is a very serious business 26 April 2018
6 PRA discussion paper DP2/22 Potential Reforms to Risk Margin and Matching Adjustment within Solvency II 28 April 2022
7 PRA consultation paper CP13/18 Solvency II: Equity release mortgages 2 July 2018
8 PRA consultation paper CP7/19 Solvency II: Equity release mortgages – Part 2 27 September 2019
9 PRA consultation paper CP23/19 Solvency II: Income producing real estate loans and internal credit assessments for illiquid, unrated assets 2 April 2020
10 PRA consultation paper CP19/23 Review of Solvency II: Reform of the Matching Adjustment 28 September 2023
11 HM Treasury Review of Solvency II: Consultation Response 17 November 2022

ATTESTATION

The ABI sees positives in the PRA's attestation proposals, including the suggested standard wording, and the focus on assets that have a comparatively high level of MA, are more complex, and/or have risk profiles that are not consistent with the assumptions underlying the Fundamental Spread.

However, the ABI is also of the view that some PRA proposals need to be revisited. Since the MA calculation is at portfolio level, it would be logical for the attestation to follow a similar approach. Further, the PRA's expectation is that firms should not offset prudence in one asset's Fundamental Spread against an insufficient Fundamental Spread in another as this would not incentivise good investment behaviour.

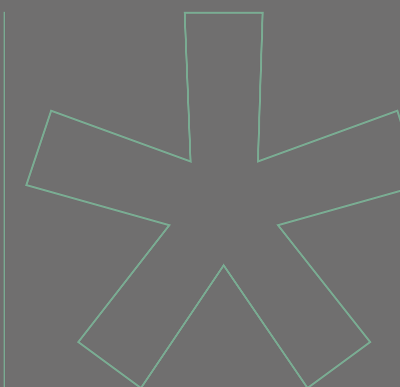
Bob Warren
ABI

Bob is a Senior Policy Adviser in the Prudential Regulation Team at the Association of British Insurers (ABI). He has been with the ABI for seven years, during which time his focus has been on the evolution of the Solvency II capital framework, and the ongoing transition to the new Solvency UK regime.

Prior to joining the ABI, Bob worked in insurance supervision at the Financial Services Authority, and then at the Bank of England's Prudential Regulation Authority. Before joining the financial services industry, he had a career in printing and publishing.

S.37

IT'S SAFE TO SAY THAT SCHEMES THAT WERE CONTRACTED OUT SALARY RELATED ("COSR") SCHEMES PRESENT ADDITIONAL COMPLICATIONS.



SECTION 37 CONFIRMATIONS – THE BACKGROUND

Before 16 June 2023, the provision of Guaranteed Minimum Pension ("GMP") benefits was usually considered the biggest additional complication. Although, failing to comply with Section 37 of The Pension Schemes Act 1993 ("Section 37") had been described by some as a 'ticking time bomb' threatening the validity of amendments made to COSR schemes. This was because there was uncertainty in the pensions industry regarding the impact of missing Section 37 actuarial confirmations, particularly when purported amendments affected benefits referable to both past and future service.

On 16 June 2023 the 'ticking time bomb' exploded when judgment was handed down in Virgin Media v NTL Pension Trustees II Limited (and others) (the "Virgin Media case") and the pensions industry has now been left trying to assess the damage caused.

In this article (effective as at late June 2024) I summarise what the Virgin Media case was about, explain its impact and consider what it means for bulk annuity transactions.

During the period between 6 April 1997 and 6 April 2016 when contracting out was abolished, a COSR scheme had to provide benefits that were at least as good as those provided by a reference scheme statutory standard. This was known as the "reference scheme test". A member's rights accrued in a COSR scheme during this period are referred to as "**Section 9(2B) rights**". Section 9(2B) rights were the successor provisions to GMPs, which no longer accrued after 5 April 1997.

Broadly speaking, Section 37, together with Regulation 42 of the Occupational Pension Schemes (Contracting-out) Regulations 1996, as they applied for the majority of the period between 6 April 1997 and 6 April 2016, prohibited amendments to the rules of COSR schemes in relation to Section 9(2B) rights unless the scheme actuary had provided written confirmation (a "**Section 37 confirmation**") that the scheme would continue to comply with the reference scheme test if the amendment was made.

RELEVANT FACTS IN THE VIRGIN MEDIA CASE

The case concerned the validity of amendments made in 1999 to the rules of the National Transcommunications Limited Pension Plan (a COSR scheme) which sought to reduce the rate of revaluation of pensions in deferment with retrospective effect.

The parties agreed that the alterations could not take effect retrospectively because of a limitation in the Plan's power of amendment. However, an issue arose as to whether the alterations took effect prospectively. The case proceeded, and the issues were considered, on the assumption that no Section 37 confirmation was provided at the time of the 1999 amendments.

Further amendments were made to the Plan in 2010 and, for existing members, the revaluation of deferred benefits continued on the same basis as provided for under the 1999 amendments. A Section 37 confirmation was provided at the time the 2010 amendments were made.

The question of the validity of the 1999 amendments therefore affected 430 to 450 Plan members with pensionable service between 8 March 1999 (when the 1999 amendments were made) and 21 June 2010 (when the 2010 amendments were made).

If the 1999 changes were held to be void and ineffective, benefits accrued during that period would improve at an estimated cost to the Plan of around £10m.

WHAT WERE THE ISSUES CONSIDERED IN THE VIRGIN MEDIA CASE AND WHAT WAS DECIDED?

The Court was asked to consider three issues and ruled as follows:

1.

Did Section 37 of the 1993 Act render an amendment made in the absence of a Section 37 confirmation void to any extent?

Yes. The judge concluded that the legislation "clearly" precludes amendments that have not obtained prior actuarial confirmation. It renders invalid and void any amendment to the rules of a COSR scheme which related to Section 9(2B) rights that was made without a prior Section 37 confirmation having been provided.

2.

Was any voiding effect limited to retrospective changes such that the absence of a Section 37 confirmation only invalidated alterations to benefits already accrued at the date of the alteration, or would the voiding effect also invalidate alterations to benefits to be earned by future contracted-out employment after the alteration date?

The judge decided that Section 9(2B) rights included pension rights relating to employment both before and after the date of an alteration and not just to past service.

In other words, the requirement to obtain a Section 37 confirmation before making an amendment to Section 9(2B) rights was not restricted only to amendments to rights relating to past service.

3.

Was any voiding effect limited only to adverse alterations to Section 9(2B) rights or would any voiding effect also relate to alterations that improved such rights?

The judge determined that the requirement for a Section 37 confirmation, and the sanction of voidness absent such confirmation, applied to all amendments to the rules of a COSR scheme, and not merely those which would or might adversely affect Section 9(2B) rights.

HOW DAMAGING WAS THE JUDGMENT?

The judgment has caused considerable consternation in the pensions industry. There are several reasons for this:

1. Former COSR schemes are likely to make up the majority of the over 5,000 defined benefit pension schemes in the UK and the decision could have potentially serious consequences for these schemes.
2. The judgment has left trustees (and their legal advisers) with the challenge of having to decide whether:
   a. they are obliged to undertake a thorough (and costly) review of amendments made during the period from 6 April 1997 to 5 April 2016 and try to locate contemporaneous written actuarial confirmations (a process which might well not reach a definitive conclusion, particularly because legislation did not require the written confirmation to be given in a particular form); or
   b. no such review needs to be undertaken unless prompted by a specific query or concern because trustees are entitled to assume that, when making amendments, consideration was given as to whether a Section 37 confirmation was required.
3. Many consider that rendering historical amendments invalid and void for absence of a Section 37 confirmation is excessively harsh for what might be said to be a technical breach of the legislation; especially for amendments which are not adverse and in respect of which a Section 37 confirmation would have been provided had it been sought.
4. Some also argue that the decision potentially goes against the intentions of Parliament. An earlier version of the Section 37 regime permitted retrospective validation and there is current provision in the legislation to allow regulations to be made that will retrospectively validate alterations that would otherwise be void. Indeed, the pensions industry has written to the Department for Work and Pension to urge it to consider passing such regulations in response to the judgment.

The judgment is being appealed and the hearing has been set for 26-27 June 2024. By the time this article goes to print, the appeal is likely to have been heard, however, at the time of writing, whether the appeal will address the industry's concerns remains to be seen. A lot will depend upon the issues raised before the Court of Appeal. Personally, I suspect legislative intervention to permit retrospective validation of amendments would still be helpful.

WHAT DOES THIS MEAN FOR BULK ANNUITY TRANSACTIONS?

From the perspective of a bulk annuity insurer, the judgment has little direct impact.

Even where the insurer is providing residual risk cover, they will typically exclude from that cover any additional liability resulting from an amendment that is void due to the absence of a Section 37 confirmation or a failure to comply with other execution formalities (the requirement for a Section 37 confirmation when making amendments to Section 9(2B) rights was well known before the judgment). Therefore, insurers are unlikely to insist that trustees undertake a review of amendments made during the period from 6 April 1997 to 5 April 2016 and confirm that there are no issues before either entering a bulk annuity transaction or, where a transaction has already been entered into, before buy-out.

The judgment might well impact transaction timescales as:

- trustees and sponsors of former COSR schemes contemplating a bulk annuity transaction and assessing affordability might decide to delay the decision until they have a clearer idea as to the impact of the judgment on the scheme's liabilities; and
- schemes that are already bought-in might decide they need to delay the move to buy-out until they can be certain they are securing the correct liabilities.

In practice, however, we have not seen a noticeable impact on our new business pipeline and schemes continue look to approach the market in record numbers to take advantage of their improved funding positions.

This is possibly because the judgment doesn't really expose any new risks for pension schemes that they didn't already have to grapple with when contemplating a bulk annuity transaction; trustees have always had to consider what steps they need to take to satisfy themselves that all necessary amendment execution formalities have been complied with.

THAT SAID, LIKE THE REST OF THE INDUSTRY WE WILL BE KEEPING A CLOSE EYE ON THE OUTCOME OF THE APPEAL...

Stephen Longfellow
Rothesay

Stephen joined Rothesay in May 2021. He is a member of the Business Development team and, given his legal background, also oversees the execution of new bulk annuity transactions. Prior to joining Rothesay, Stephen was a pensions lawyer with over 10 years' experience. He specialised in pension risk transfer and advised Rothesay as external legal counsel as well as advising trustees and sponsors.

LONGEVITY SWAPS – HAS DEMAND CHANGED?

CANADA LIFE REINSURANCE HAS BEEN REINSURING UK LONGEVITY RISK SINCE 2008 AND WE HAVE SEEN A DISTINCT SHIFT IN THE LONGEVITY SWAP MARKET OVER THE PAST FEW YEARS.

FIVE TO TEN YEARS AGO, MOST OF OUR TRANSACTION PIPELINE WAS COMPRISED OF LONGEVITY SWAPS WITH PENSION SCHEMES.

The trustee would select the reinsurer and then execute the transaction via a pass-through structure utilising either a UK insurer or a captive cell arrangement. More recently, a handful of large pension scheme swaps have come to the market each year but the bulk of (excuse the pun) our pipeline has come from supporting the insurers with their bulk annuity transactions.

There are a few drivers behind this shift. As over 90% of UK defined benefit schemes are now closed to new members[1], there will come a stage where buy-out makes economic and operational sense for most trustees and sponsors. High interest rates, COVID-19 mortality spikes and the ensuing slowdown of UK mortality improvements have simultaneously led to significant improvements in longevity reinsurance pricing and in pension scheme funding levels. This has materially reduced demand for pension scheme longevity swaps relative to bulk annuities as more trustees can now afford to go more directly towards their endgame via a buy-in or buy-out.

1 PPF Pension Book 2023

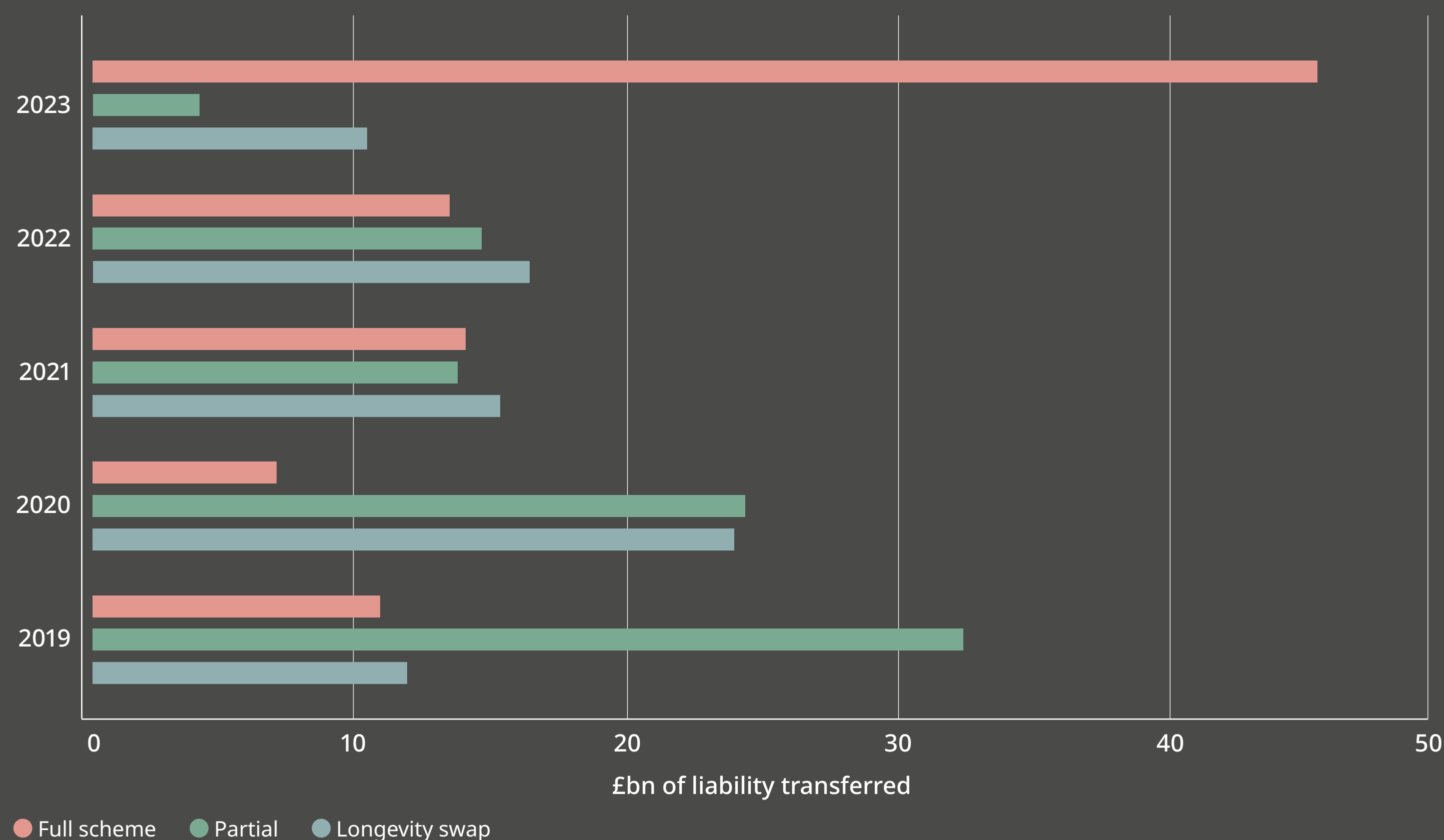
LONGEVITY REINSURANCE PRICING

Although significant uncertainty remains around the outlook for post-pandemic mortality improvements, reinsurers have generally now reflected the impact of the COVID-19 pandemic and made some allowance for a post-pandemic slowdown of mortality improvements in their basis. High interest rates have reduced the present value of liabilities and kept downward pressure on fees. As these developments have also led to significantly increased funding levels for pension schemes, demand for longevity de-risking solutions in the UK is at an all-time high. Usually, soaring demand would lead to price hardening, but continued new entrants (including funded reinsurance players) and a perception that the current market boom will be finite has meant that, to date, reinsurance pricing has remained extremely keen.

The complexity of longevity reinsurance transactions has increased. Inclusion of deferred risk is becoming market standard and funded reinsurance pricing is now requested from many insurers in addition to the traditional vanilla reinsurance pricing. The largest obstacle to longevity de-risking in the current market therefore appears to be finite human resources in the relevant tender/pricing/execution teams rather than reinsurer risk appetite or capacity limits. We are seeing the market respond to this with more limited (or even exclusive) participation processes. Pension schemes are partnering with single insurers; insurers and reinsurers are partnering where it makes sense to do so, and triaging deals and being selective in what they prioritise to focus on profiles that suit their pricing models.

BULK ANNUITY AND LONGEVITY SWAP VOLUMES – 2019 TO 2023

Figures are approximate. 2023 figures are projected based on WTW estimates



Based on WTW led transactions, announcements in the pensions news and insurer reports, and WTW interpretation of partial or full buy-in
Source: WTW, December 2023.

FUTURE OUTLOOK

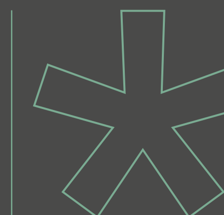
I see this change in focus to buy-ins and buy-outs over swaps as a permanent shift as the market matures and more pension schemes reach the final stages of their de-risking journey plans. However, increased funding levels over the past year or two have certainly accelerated that trend. Therefore, significant interest rate reductions could put a full scheme buy-out out of reach again for some schemes, particularly those that haven't readjusted their asset allocation to lock into their improved funding levels. Economic conditions will always lead to some short-term fluctuation but over the medium term, the market evolution should continue to shift slowly but surely towards bulk annuities.

Despite the trend towards bulk annuities, I predict that some pension schemes will continue to choose longevity swaps due to their specific circumstances. Size and industry are very relevant to the de-risking strategy agreed by trustee and sponsor. For example, "jumbo" pension schemes incur lower marginal costs and therefore are under less pressure to wind-up, even as the scheme membership matures. Financial services schemes may have a higher appetite to retain investment risk. A longevity swap enables the trustee to retain control over the assets which could lead to higher returns. Similarly, a very involved sponsor with a strong covenant and appetite for risk may prefer to delay a move to buy-out. The Mansion House reforms announced in July 2023 imply that the government may look to change the rules regarding surplus refunds to boost investment levels in productive assets. This could increase the perceived value in running the scheme as a going concern and make longevity swaps more attractive relative to buy-out. Other specific circumstances could contribute, for example direct swaps may make sense for repeat deals with the required contracts and related infrastructure already in place (although we regularly see novation of existing swaps to insurers as part of a buy-in or buy-out, so either option is viable). Superfunds are also an option for some, although unlikely to become the default choice in the market.

Finally, there will always be some volatility year on year due to the binary nature of whether a large pension scheme decides to execute a swap or not. 2023 saw market volumes of around £50bn with two transactions of around £5bn - the BT Pension Scheme longevity swap and the Boots Pension Scheme's buy-in. Another significant transaction was the £4bn Co-operative Pension Scheme buy-in with Rothesay, which we were pleased to support them on. We have some even larger transactions in the 2024 pipeline but at this stage, considerable uncertainty around precise execution timing remains.

In a busy market, it makes sense for trustees to consider their options carefully and set their de-risking strategy accordingly. The insurance and reinsurance industry can support a variety of structures and are open to innovation to facilitate meeting the market's needs. We expect that a minority of schemes will continue to prefer direct swaps because it is the right choice for them.

HOWEVER, BUY-OUT IS THE DESIRED ENDGAME FOR THE MAJORITY, AND IT NOW APPEARS TO BE WITHIN REACH OF MORE PENSION SCHEMES THAN EVER BEFORE.



I SEE THIS CHANGE IN FOCUS TO BUY-INS AND BUY-OUTS OVER SWAPS AS A PERMANENT SHIFT AS THE MARKET MATURES AND MORE PENSION SCHEMES REACH THE FINAL STAGES OF THEIR DE-RISKING JOURNEY PLANS.

Sheila Harney
Canada Life Reinsurance

Sheila leads the Longevity Business Development team at Canada Life Reinsurance. She is a qualified actuary with over 15 years' experience across reinsurance, insurance and consulting roles in the UK and Ireland. For the past ten years, her focus has been on the pricing and execution of longevity reinsurance transactions in Europe. This has included large UK pension scheme swaps (e.g. BBC, National Grid, British Airways) and supporting insurers with a variety of longevity and asset de-risking solutions.

CASE STUDY

IN LATE 2021, THE CO-OPERATIVE PENSION SCHEME (THE "SCHEME") RAN A COMPETITIVE TENDER PROCESS TO IDENTIFY AN INSURER TO PARTNER WITH OVER A MULTI-YEAR JOURNEY TO SECURE ALL £7BN OF THE REMAINING UNINSURED LIABILITIES OF THE CO-OP SECTION OF THE SCHEME.

THE CO-OPERATIVE PENSION SCHEME

In March 2022, following a competitive tender process, a Joint Working Group ("JWG") of the Scheme's Trustee and Sponsor entered into exclusivity with Rothesay as the first step on this journey.

Working with their advisers from Aon and Linklaters, the JWG established a Project Board who worked with Rothesay to plan the various steps required to secure all remaining uninsured liabilities of the Co-op Section of the Scheme. The JWG set out to also secure "residual risk" cover relating to the Scheme's liabilities, which passes data and benefit risk on to Rothesay as part of the insurance contract. The first step in this process was to populate a data room and arrange facilities for operational due diligence to take place, ahead of a proposed first tranche of insurance of circa £1.5bn to be secured in October 2022.

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. Working on over £60bn of transactions, Sammy has played a lead role in transactions with the pension funds of Co-op, 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.

PRICE LOCK MECHANISM

From exclusivity, Rothesay was able to provide pricing certainty to the JWG through a "price-lock" mechanism by defining the insurance premium as a portfolio of the Co-op Section's assets plus a balancing portfolio of cash and gilts. This meant that the Scheme could satisfy payment of the insurance premium by simply transferring this portfolio of assets to Rothesay when ready, which helped mitigate the economic risk of the associated assets and liabilities over the execution period.

In parallel with planning for securing the Co-op Section, the Trustee decided to seek pricing for a separate section of the Scheme, the Bank Section. Rothesay's pricing for this section was also deemed attractive and again, the quoted insurance premium was converted to a portfolio of the Bank Section's assets. The partnership arrangement now covered more than £8bn of total Scheme liabilities.

RESIDUAL RISK DUE DILIGENCE

In the summer of 2022, 31 employees across Rothesay's pricing, in-force, transitions and business development teams were involved in 8 weeks of extensive on-site due diligence. Over this period, the records of nearly 3,000 current and former members were reviewed in detail as Rothesay worked closely with advisers and the Scheme's large and experienced in-house pensions administration team.

The Scheme itself is an amalgamation of more than 40 former and acquired schemes, each with their own history that in some cases stretches back almost 100 years. This long and complex history gave rise to a data room containing over 2,800 legal files that were considered as part of our data, benefit and legal review of the benefits due to the more than 70,000 members who are currently receiving or entitled to receive benefits from the Scheme. Under the terms of the exclusivity agreement, Rothesay had also offered to provide residual risk cover against liabilities already secured in previous transactions with two other UK BPA providers.

When the JWG first agreed to work with Rothesay we did so recognising that to deliver our risk transfer project successfully, delivering further benefit security to our members, we needed the relationship to be a genuine partnership. Rothesay also understood this and demonstrated those behaviours from the start. All longterm complex transactions have bumps along the road but Rothesay and the JWG were able to work openly and constructively to overcome these. Indeed, there are few larger bumps than those arising from the 2022 "mini budget" but the partnership with Rothesay allowed us to co-create innovative solutions and to successfully navigate even these obstacles.

"PARTNERSHIP" IS A SLIGHTLY OVER USED WORD IN OUR INDUSTRY, BUT IT GENUINELY FITS FOR HOW ROTHESAY WORKED WITH US.

Chris Martin
Executive Chair – Independent Governance Group

The original transaction timeline had envisaged an initial tranche executing in October 2022, which coincided with the market turbulence associated with the UK Liability Driven Investment (LDI) crisis. Whilst the price certainty offered by our price-lock mechanism would have allowed the initial tranche to be executed as planned, the JWG determined that it would be prudent to pause in order to ensure that all of the remaining liabilities of the Scheme could still be secured safely following execution of the initial tranche.

The key consideration was around the illiquid asset holdings that the Scheme had planned to sell or run-off over time whilst securing the remaining liabilities in tranches. Without certainty around the ultimate realisation value of those investments, it was difficult for the JWG to guarantee that all liabilities of the Scheme could be safely secured under the staged approach initially proposed.

It became clear that a transaction in stages was not going to be the optimal solution, and that the only way to safely start on this journey of securing all of the Scheme's liabilities was for Rothesay to provide certainty regarding the Co-op Section's illiquid assets as well as all of the remaining liabilities of the Scheme.

BANK SECTION

In the short term, attention quickly turned to the Bank Section of the Scheme, which did not have any material exposure to illiquid assets. The price-lock, which had been offered in the summer of 2022, was maintained throughout the LDI crisis and, in early December 2022, all the remaining uninsured liabilities of the Bank Section were secured with Rothesay. Additionally, a legal agreement was entered into for Rothesay to provide residual risk cover against the liabilities previously insured elsewhere with another BPA provider.

ILLIQUID ASSETS

Exclusivity for the Co-op Section was extended at the end of 2022 and, at the request of the JWG, Rothesay provided a proposal for this section which incorporated the Co-op Section's illiquid assets in a single transaction covering all of the Co-op Section's remaining liabilities. These illiquid assets, representing circa £1bn of the Co-op Section's assets, had originally been out of scope for the proposed staged approach to the transaction, so a new due diligence exercise was commenced by Rothesay to underwrite a number of properties, Asset Backed Security (ABS) funds and other fund holdings including Private Equity.

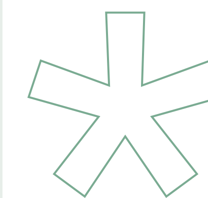
EXECUTION

In the summer of 2023, having provided a proposal which met the objectives of the JWG, Rothesay began execution of a transaction for the entire Co-op Section. Working with Aon, Linklaters and Mercer as the investment consultant, Rothesay and the JWG partnered to effectively coordinate the sale of a number of the illiquid asset holdings of the Scheme, with the sale proceeds being ultimately underwritten by Rothesay.

With this process well underway, the job of transferring property and other assets could begin as the transaction reached execution in the final quarter of 2023. Ultimately, various investment funds and multiple property investments were transferred to Rothesay alongside a portfolio of corporate bonds and gilts that were owned by the Scheme. Rothesay worked collaboratively with the JWG and its advisers to ensure the smooth transfer of the Scheme's existing asset holdings, avoiding the need for a significant portfolio transition in advance of the transaction.

One of Rothesay's main strengths is their problem solving – coming up with ideas for a complex asset transition that reduced risk and met our objectives (for example, where we held illiquid and harder to price assets, or hedging instruments). Rothesay also have strength in the depth in their team, and in both transactions Co-op Pension Scheme has done with Rothesay, the transition (of large numbers of holdings) has been well managed and straightforward, with Rothesay partnering well with our custodian and advisors.

James Giles
Head of Pensions Investment and Risk – Co-op



OUTCOME

The efforts and cooperation of Rothesay, the Trustee, the Sponsor and their advisers resulted in completion of the buy-in for the Co-op Section by the end of 2023. All parties worked together collaboratively and productively over an extended period of time in order to achieve the best outcome for the JWG. Rothesay was able to evolve and adapt its offering to the changing conditions and tailored the transaction structure to best meet the needs of the client.

Designing insurance for this scheme required a highly bespoke solution, given its size, benefit structure complexity and evolved asset strategy. Rothesay worked tirelessly and collaboratively with the project team to identify potential pitfalls and develop solutions to meet the Scheme's needs. It was ultimately this collaboration and innovation which made the deal possible.

Martin Bird
Senior Partner – Aon

Chapter 3

Illiquid assets

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Welcome to the endgame
Chapter 3
Illiquid assets

For many schemes approaching buy-out, preparation of the asset portfolio for transfer to an insurer is an important objective. Gilts, cash and corporate bonds are widely accepted by insurers as premium, and historically schemes have positioned their portfolios into these assets as part of preparing to approach the bulk annuity market.

Introduction

The significant rise in interest rates seen in 2022 led many schemes to a position of full funding much faster than previously expected. This in turn has led many schemes to accelerate plans for approaching the bulk annuity market to secure their members' benefits, sometimes by a number of years. As timings have been brought forward, schemes have not had the time to re-position their portfolios into liquid assets as originally planned for.

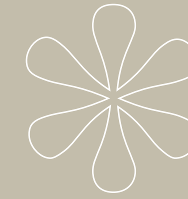
As a result, many schemes are coming to market with asset portfolios that hold a material concentration in illiquid assets; these often have risk and cashflow characteristics very different from the gilts, cash and corporate bonds more typically held by insurers and historically used to pay buy-out premiums. Insurers have consequently been adapting to a new market dynamic where illiquid assets and their potential inclusion as part of premium payment are part of the buy-out process. The ability of insurers to provide solutions for illiquid assets has become an important consideration to enable schemes to transact in full and take advantage of their improved funding positions.

Rothesay has responded by establishing a new Illiquid Asset Transition team which has helped to prepare the business to provide capacity for even the largest and most complex risk transfer transactions. This team supports an increasing number of schemes coming to market with exposure to illiquid assets, offering illiquid asset solutions tailored specifically to each scheme's needs and holdings. Over the course of 2023 this team performed in depth analysis on over 90 illiquid asset and fund positions.

We aim to provide price certainty on asset portfolios from early on in a process by "locking" pricing of the scheme's assets, providing a means for transitioning or transferring schemes' existing asset holdings in full – including its illiquid assets where possible. Deferred premium structures can provide an alternative solution, allowing pension funds to lock in their funding position and manage the sale of illiquid assets over a long period that isn't tied to the timing constraints of a buy-out process.

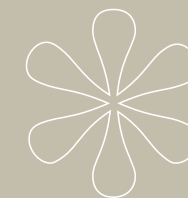
Over the next few articles we explore illiquid assets from the perspective of an insurer, a consultant, as well as the legal considerations.

Investment

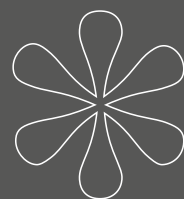


What is an ‘illiquid asset’?

Illiquids



How to prepare



What is an ‘illiquid asset’?

While there is no strict definition of the term, we can consider an “illiquid asset” to be one that cannot be easily or quickly sold on a market or exchange.

In the context of pension scheme investments the phrase most often refers to assets that are managed by a third party asset manager exercising investment discretion on behalf of the scheme, typically held either as:

1. Shares or units in a co-mingled investment fund, where the scheme is one of several investors with a common interest in the fund’s performance; or
2. Investments held within a segregated Separately Managed Account (SMA), where the scheme is the sole investor.

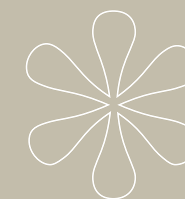
The term “illiquid asset” can refer either to the fund investment itself, or to the underlying assets held by the fund or investment vehicle. In the case of co-mingled funds – particularly closed-ended funds – investors often do not have direct access to the underlying assets or the ability to direct the manager to sell, so an owner that wants to raise near term liquidity will look to sell its whole fund position. SMAs in contrast typically offer periodic redemption rights under which the manager can be directed to dispose of some or all of the underlying assets.

Underlying exposures may incorporate a range of asset classes and investment strategies, encompassing the full spectrum of risk and reward profiles, cashflow characteristics, and market liquidity. To the right we describe many of the asset classes regularly held by pension schemes:

It is important to highlight that some illiquid investments held by schemes will be a natural fit in terms of the risk and structural characteristics that Solvency II/UK insurers require for efficient investment. (Put simply, most Solvency II/UK insurers seek to invest in predominantly investment grade fixed income assets with fully predictable cashflows.)

For assets that are not a natural fit, an insurer looking to provide price certainty or otherwise underwrite these assets as part of a bulk annuity deal will need to consider which each assets can be held in the long term on the balance sheet, and if so at what price such a long term hold meets investment hurdles. For assets that cannot be held long term, insurers will investigate options for seeking redemption or selling into the market, and the potential market value risk such an approach entails. Given that insurers aren’t always the natural holders of these assets, trustees should also consider whether to sell their scheme’s illiquid assets through brokers outside of the pension risk transfer process – this may lead to the best pricing outcome.

Asset class	Description
Illiquid Investment Grade Loans / Private Placements	Loans to investment grade corporates, project finance / infrastructure or other borrowers. Often these are similar to, or the same, in terms of risk profile and structure as typical investments held by insurers. These might be in the format of private placements, syndicated loans, or direct bilateral loans.
Commercial Real Estate Debt	Secured loans backed by commercial real estate. These are often senior investment grade loans, though some mandates hold higher leverage or subordinated positions which are sub-investment grade.
Long Income Real Estate	Property investments offering long term contracted income.
High Yield Infrastructure Debt	Loans to infrastructure projects with higher leverage or riskier cashflow profiles than investment grade projects.
Private Corporate Credit	Loans to high yield corporate borrowers, often originated by managers on a bilateral basis.
Structured Finance and ABS	Bonds or loans where risk level varies depending on the seniority of tranche and underlying asset characteristics.
Distressed / Opportunistic Credit	Distressed loans or hybrid securities. These can include debtor in possession or highly subordinated loans.
Infrastructure Equity	Lower risk infrastructure equity can include ownership of stable and highly contracted cashflows. Higher risk infrastructure equity may carry more market or development risk.
Real Estate Equity	Property investments with multiple tenants or shorter leases than long income real estate.
Private Equity	Equity investments in private corporates, typically supported with leverage froma private credit investor.



How to prepare

Illiquids

Ahead of a buy-in / buy-out process, a scheme should be mindful of what actions it can take with its illiquid asset portfolios:

1. Consider not making any further commitments to illiquid assets if a pension risk transfer process is anticipated in the short to medium term.
2. Take advantage of all opportunities to run off the portfolio, including submitting any redemption requests where possible – especially if the fund operates a redemption queue.
3. Communicate to managers that a transfer in connection with a buy-in / buy-out may be upcoming, and cooperation will be needed as well as consent to transfer if so required. It is possible that they may be able to offer solutions. This will also help to flag any potential concerns that a manager may have with information provision or transferability.

Access to information will be an important factor for insurers evaluating illiquid assets. As noted above it is worth engaging with managers on this point ahead of time. Typical information requirements may include:

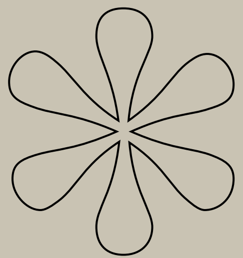
1. Fund vintages, investment dates and size of undrawn capital commitments (if any).
2. Latest and historical financials and reporting.
3. Current and historic Net Asset Value / capital account statements, and/or asset valuations.
4. Fund / underlying investment cashflow projections.
5. Data tapes with details of underlying assets.
6. Limited Partnership Agreements (LPAs) / Investment Management Agreements (IMAs) and any side letters, where applicable.
7. Distribution and drawdown history.
8. Manager calls for discussion of portfolio performance, past and expected.

Access to information will be an important factor for insurers evaluating illiquid assets - it is worth engaging with managers on this ahead of time.

Al Robinson
Rothesay

Al has been a member of the investment team at Rothesay since 2012. He has been responsible for a wide range of Rothesay’s illiquid and long-term investments in key sectors including structured finance, secured lending, social housing, public finance and private credit. He has played a lead role in Rothesay’s efforts to assist pension scheme clients with solutions for their illiquid asset portfolios as part of their bulk annuity transactions. Prior to joining Rothesay, Al worked in Structured Credit at HSBC where he began his career.

Illiquid assets as part of an insurance transaction



preparation & options

Many pension schemes have invested in private market assets (direct lending, infrastructure, property) to take advantage of the attractive characteristics of predictable cashflows and an illiquidity premium.

However, the hurdle for taking on illiquidity has increased as:

- collateral pools have increased following the gilts-crisis; and
- the timeframe for achieving a full buy-in for closed pension schemes has reduced significantly as pension scheme funding and absolute deficit levels have improved.

Several of our clients completed full buy-in transactions in 2023 and, in each case, the illiquid private market assets held by the schemes were a significant aspect of the transaction influencing the overall cost and the selection of the preferred insurer. Based on our recent experience, we have shared our thoughts on steps pension schemes should take in preparation for a full buy-in transaction and the options available for selling illiquid assets.

1

Give yourself ample time

Under an expedited sale process, the discounts applied to the value of illiquid assets by secondary buyers can be significant (up to 30%-40%). Significant value could be saved by ensuring you have sufficient time to complete an orderly sale.

Typically, the best value would be achieved by allowing these investments to return capital naturally, which may be an option for shorter-dated lending funds. However, in many cases a sale is likely to be required.

Steps to consider 5 + years ahead of a possible transaction

1. Review your objectives and the range of timeframes to achieve a full buy-in.
2. Assess the redemption profile of your private market portfolio including fund extension terms.
3. Consider which assets could run-off within the likely timeframe to buy-out and identify those where a sale will be required.
4. Where sales are required, considering getting on with this!

Steps to take as part of considering a transaction (18-24 months in advance)

1. Make your investment manager aware that you are open to opportunistic sales.
2. Issue redemption requests well in advance – particularly for property funds where notice periods are long, and managers often have flexibility to defer.
3. Determine possible buyers and their needs and objectives.

2

Different approaches may be required for each asset to achieve the best value

The 'best' approach for selling private market assets will vary depending on the type of investment. Potential buyers will have a variety of objectives which will determine the price they are prepared to pay as providers of liquidity.

The main routes available for exiting these assets are:

Other UK pension schemes

Other UK pension schemes should be able to offer the competitive prices in most cases as their objectives are broadly aligned. However, many pension schemes are looking to sell these types of assets and there may be a limited number of buyers.

Traditional secondary market buyers

These buyers often have return objectives well above most pension schemes. To meet their objectives, these buyers typically target higher returning asset classes (private equity, opportunistic credit, leveraged/ mezzanine debt funds). For higher quality and lower yielding private debt funds, secondary market buyers would need to purchase these assets at sizeable discounts to achieve their return objectives so an alternative approach may provide better value.

The secondary market for private debt funds is relatively new albeit several secondary funds have been launched recently. These funds could provide a compelling option in the future.

It is important to cast the net as wide as possible to achieve the best value from secondary market sales. This would typically require the appointment of a secondary market broker and could take around six months to run a full process once a broker has been selected. Planning for this should start well ahead of any transaction.

The insurer (deferred premium)

In select cases, some insurers may be prepared to defer part of the premium payment (up to c10%) which could allow time for an orderly redemption of any semi-liquid assets and/or to receive capital back from short-dated assets. However, the term of any deferral is likely to be limited to 18-24 months with interest applied to the amount being deferred.

The insurer (as a purchaser)

A key decision for our clients in selecting their preferred insurer was the support that could be provided to take on illiquid assets. We believe this is a relatively new development as insurers have historically only taken on risk free assets and high-quality bonds. Clearly, insurers have different objectives to most pension schemes and capital requirements to satisfy. For higher quality debt assets that fit an insurer's investment portfolio and satisfy the Matching Adjustment criteria, some insurers could provide competitive pricing to purchase these assets relative to other buyers. However, for lower quality assets that are more capital intensive, there would likely be a more significant price discount or insurers may simply be unable to offer a solution.

The sponsor

This is probably a last resort as few sponsors would be prepared to take on assets from the pension scheme. Care needs to be taken to ensure an arms-length transaction and the purchasing entity would need to satisfy the investment managers' Anti Money Laundering and Know Your Customer requirements. Before considering this option, you should ask your investment manager(s) whether there are any reasons they may withhold consent for transferring the scheme's interest(s) to a corporate entity.

3

Final thoughts

Many closed UK pension schemes are targeting full buy-in to buy-out, including larger schemes with complex investment portfolios that often include illiquid private market investments. The need for pension schemes to offload illiquid assets to maintain sufficient collateral or as part of an insurance transaction is likely to increase in the coming years while there are limited buyers of lower yielding pension scheme assets. From our recent experience, it is encouraging to see that some insurers can help to provide a solution for higher quality assets, but their capacity and willingness to do so may be limited. Given the potential for sizeable discounts being applied to the sale of these assets, trustees should carefully consider their private market allocation and develop a clear plan for exiting these investments, ideally, well ahead of any buy-in transaction.

Peter Hall
Momentum

Peter is a Partner at Momentum and has been advising large pension schemes on all aspects of investments for over a decade having worked at Mercer prior to establishing the UK consulting team at Momentum in 2015. He has also worked in the insurance industry and qualified as an actuary in 2007.

Illiquid assets – the legal considerations

1 Introduction

Changes in market conditions have accelerated many schemes' journey plans, making it more common for trustees to consider an insurance transaction where scheme investments include illiquid assets which are needed to pay part of the premium. The key legal considerations are covered here.

2

Realising value from illiquid assets: open-ended funds

Certain fund interests can be "redeemed" or "liquidated" at a limited partner's (the trustee's) discretion. The option to redeem or liquidate is more common in open-ended fund structures. Trustees should be mindful:

- of the permitted redemption dates (which need to be aligned to the transaction timetable);
- of limitations regarding the number of interests that can be redeemed on any redemption date; and
- that fund managers are unlikely to permit the redemption or liquidation of interests which carry capital call rights (contractual obligations to commit further capital to the fund).

If the trustee can redeem or liquidate its fund interests on acceptable economic terms, the realised funds can be paid to the insurer.

3

Realising value from illiquid assets: closed-ended funds

The Secondaries Market

For closed-ended fund structures, trustees may be able to explore a sale of their fund interests to a third party. The growth in size, and the increased sophistication, of this market means there are more potential buyers for schemes' illiquid assets and, as the market develops, trustees are increasingly able to benefit from the kind of protections that are available to sellers in traditional M&A transactions.

Role of the scheme's investment manager or third-party broker

Trustees should agree the scope of their investment manager's role at the outset of any secondary market transaction. It may also be necessary or desirable for trustees to appoint a specialist third-party broker to assist with the process. In either case, trustees are likely to require the following support:

- marketing the illiquid assets;
- advice as to the value of the illiquid assets; and/or
- support with the transfer of the illiquid assets to the buyer at completion.

Key provisions in the fund and M&A documents

In general, the transfer of fund interests is subject to the consent of the fund manager, therefore early engagement with the fund manager and the ability to obtain consent should be considered as part of the wider transaction timeline.

Changes in market conditions have accelerated many schemes' journey plans...

Due Diligence / Fund Documents
An initial exercise should be undertaken to determine any potential impediments.

In particular:

- a transferability analysis to assess in broad terms whether the transfer provisions permit the contemplated transfer (and any conditions that apply will need to be considered carefully) and to identify whether any other restrictions would be triggered, such as a right of first refusal or a right of first offer; and
- any restrictions applicable to the buyer (as the incoming investor), including any KYC or onboarding required by the fund prior to completion.

M&A Documents
The primary legal documentation that governs the sale of the illiquid assets is the sale and purchase agreement (the "SPA"). Key features of the SPA are:

- **Purchase price adjustments:** Typically fund interests will be priced (discount/premium to NAV) as at a specific reference date and adjusted to reflect (i) any distributions paid by the fund, and (ii) any capital calls advanced by the scheme, in the period between signing the SPA and completion.
- **Excluded obligations:** The liabilities that are expected to be retained by the trustee as seller will be a subject of negotiation. As a starting point typically these cover obligations attributable to the trustee during the course of its ownership of the fund interests such as those arising from its tax obligations, give back obligations, and any breach of fund documents. This will require careful consideration because the scheme may have minimal assets following the insurance transaction and, in the case of a buy-out, is likely to be wound-up.
- **Conditions to completion:** The trustee will want a high degree of confidence that any conditions to completion are within the trustee's control or are likely to be satisfied. A failure to satisfy the conditions will result in the secondary transaction not completing and there may be a shortfall in premium under the insurance contract.
- **Tax:** Transfer taxes are a key issue on secondary transactions, these include taxes that are payable when transferring ownership through to indirect transfer tax considerations such as withholding tax. Ultimately, these issues are addressed by a combination of early tax advice and contractual risk allocation between the parties.

Transfer Documents
The parties will enter into a transfer document which, together with any subscription documents, functions as the document admitting the buyer into the fund in assuming the seller's responsibilities under the underlying fund documents.

Intergrating secondaries into insurance contracts

From a practical perspective, the insurance contract and the secondaries transaction will need to be linked and the processes highly integrated.

Sale to a Third Party

The most common approach is to sell the illiquid assets to a third-party and transfer the proceeds to the insurer. Trustees should note:

- It may be challenging to do so during the price lock period. Many insurers are able to defer a portion of the consideration payable, giving the trustee time to realise illiquid scheme assets. This will however need to be negotiated as part of the insurance transaction.
- The value of the fund interest needs to be fixed at a point in time (usually the beginning of the price lock) for insurance pricing purposes.
- The insurance contract will need to specify what happens if the trustee is unable to sell the illiquid asset within the prescribed time. For example: a "Termination Event" under the insurance contract; scale back of the insured benefits; or an employer underwrite (where the employer steps in as buyer if the third-party process falls through).

Sale to the insurer

The insurer may accept payment in specie, with the fund interest being transferred directly to the insurer. In addition to the points raised above, trustees should consider:

- How to ensure that the price discovery process is robust.
- The terms which would apply to any Termination Event if the failure to transfer the illiquid assets in specie results from either a trustee or an insurer (rather than a third-party) fault.
- As explained above, distributions and capital calls can occur during the secondaries transaction and the insurance contract will need to include a true-up mechanic which adjusts the premium payable by reference to the amount of distributions received by the trustee, and any capital calls advanced by the trustee, before the illiquid assets are transferred to the insurer.
- Who bears any transaction costs and/or any tax payable in connection with the transfer of interest.

Joseph Wren
Travers Smith

Joseph Wren is a finance partner at Travers Smith, where he advises pension schemes, sponsors and insurers on investment, covenant, de-risking and endgame. Over the past decade, he has advised on some of the largest de-risking transactions in the market (including for the British Steel Pension Scheme, the ASDA Pension Scheme, the Nortel Networks UK Pension Plan, and the Thales UK Pension Scheme) as part of Travers Smith's Pensions Sector Group. He is ranked by Legal 500 UK and Chambers UK and is also Travers Smith's Corporate Social Responsibility Partner.

Chapter 4

Wrapping up

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mallowstreet survey results:

Buy-out continues to be the endgame plan for many schemes

The results in this publication for 2024 are based on a survey of 70 pension schemes. The key statistics detailed below are based on 5 years of survey data collected between 2020 and 2024.

This year's results continue to show improving funding levels. Buy-out remains the key endgame plan, although there's more interest in those considering a run-off strategy.

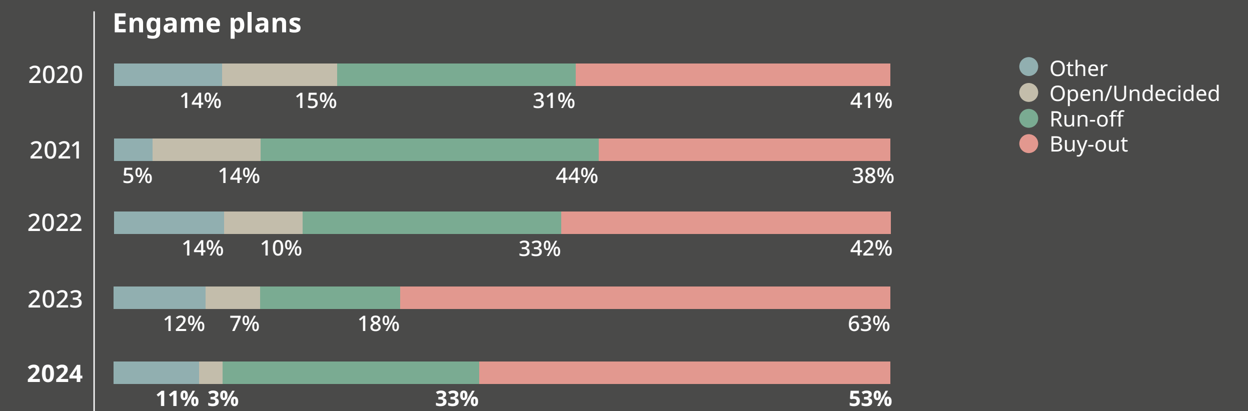
Whilst many schemes looking to buy-out have made progress on managing their illiquid asset exposures, it remains a key challenge for many.

Additionally, buoyant funding levels mean schemes increasingly have to deal with potential surpluses as well as considering non-pricing factors such as member experience when assessing insurers.

Smaller schemes remain concerned they will not be able to transact with an insurer, but evidence from the market suggests those who have planned and prepared accordingly are able to successfully complete a transaction.

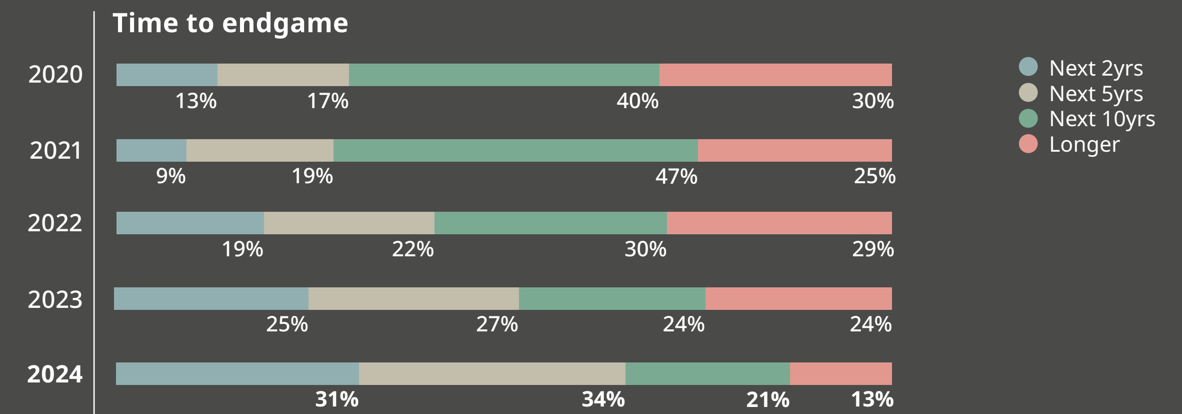
Buy-out remains key endgame plan

Buy-out continues to be the endgame plan for many schemes, with 53% surveyed in 2024 targeting buy-out. There's increased interest in considering run-off, most likely in light of the proposed Mansion House reforms that aim to incentivise schemes to do so.



Many schemes are closer to their endgame

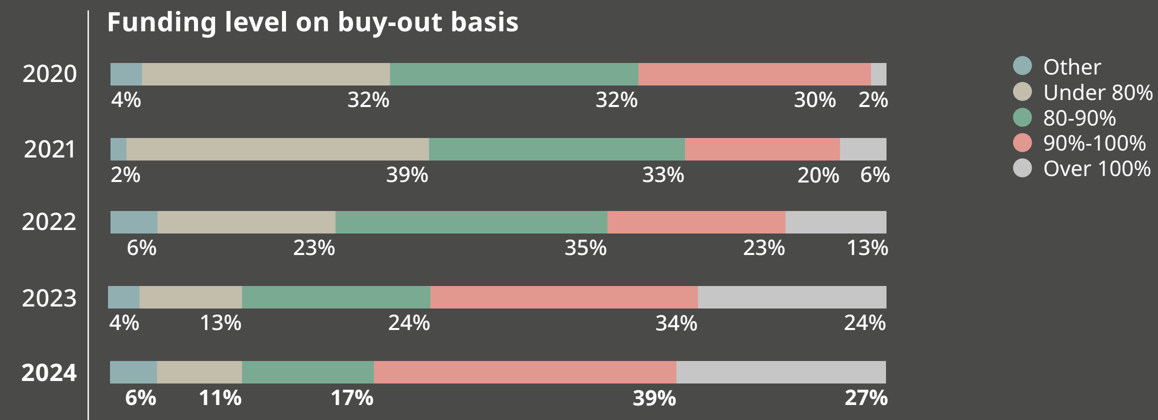
The last 5 years of data show a trend of schemes increasingly getting closer to their endgame. In 2020, 30% of schemes surveyed stated their endgame was more than 10 years away; this number is only 13% in 2024.



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

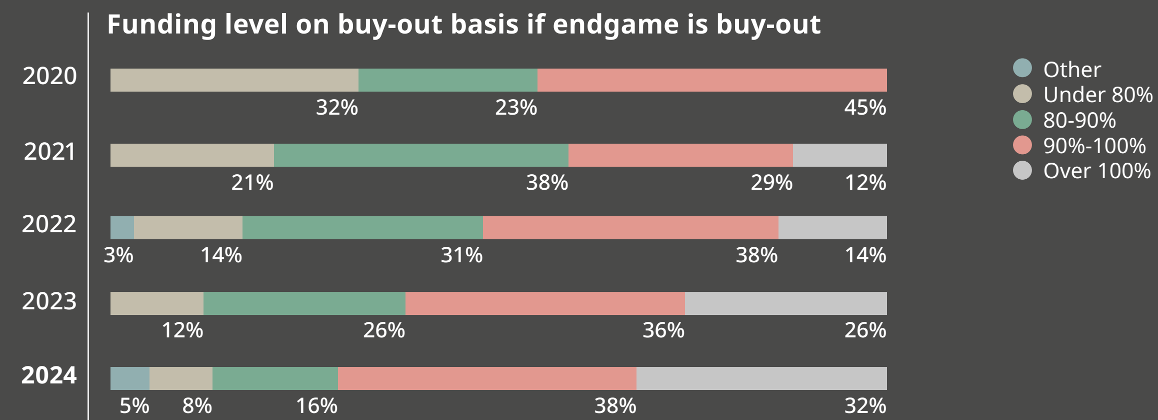
mallowstreet survey results

Schemes are better funded than they were 5 years ago



Schemes on the path to buy-out show improvement in funding levels

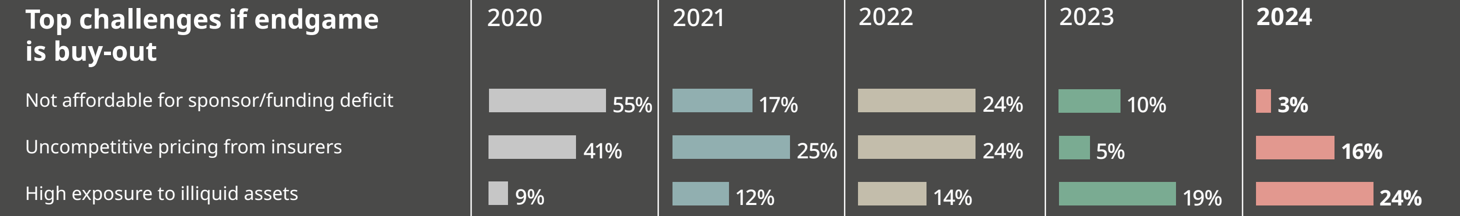
Over the last 5 years, schemes targeting buy-out have shown significant improvements in funding levels, with 32% of those surveyed in 2024 being over 100% funded on a buy-out basis. It's not surprising that the issue of surplus assets and what to do with them has moved up in priority on scheme agendas.

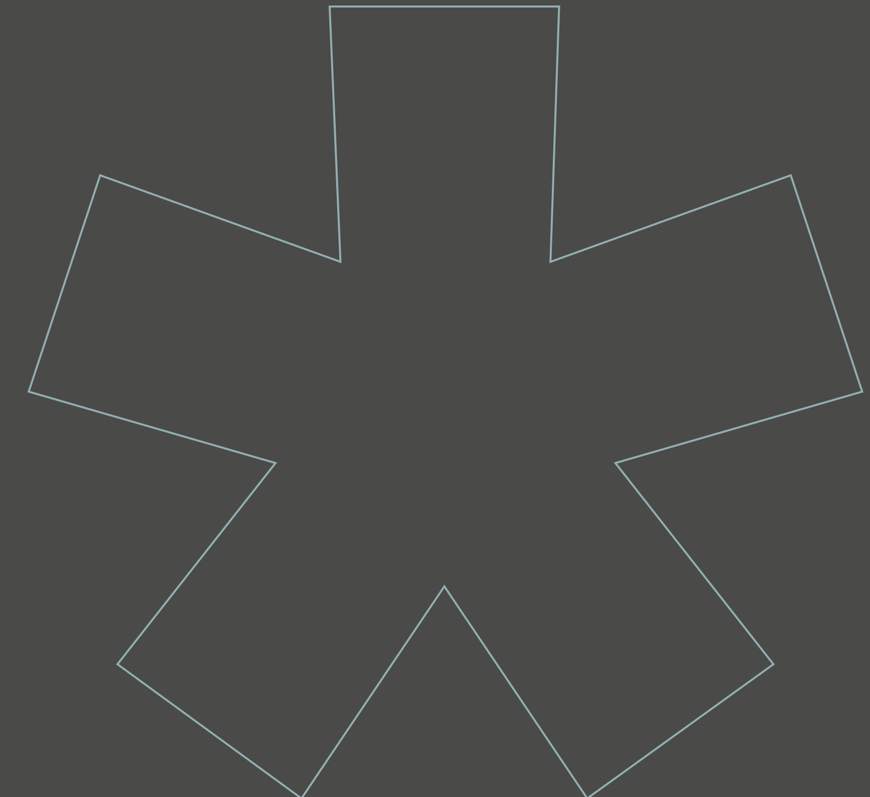


Figures in the charts may add up to 99% or 101% due to rounding of percentages

Schemes face fewer hurdles on road to buy-out

When we started this research in 2020, the main challenges to buy-out were affordability and uncompetitive pricing from insurers. However, a high exposure to illiquid assets is now the key challenge for many schemes – in particular those which became fully funded earlier than they'd previously anticipated.



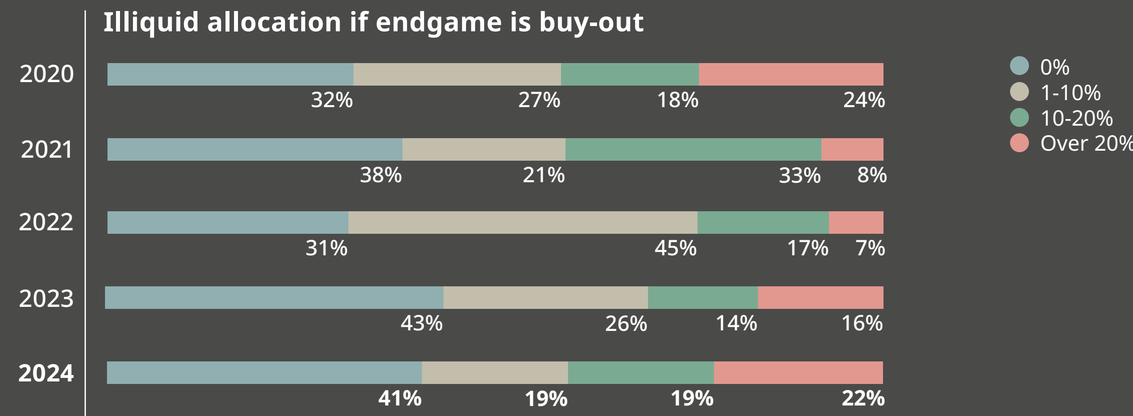


Figures in the charts may add up to 99% or 101% due to rounding of percentages

mallowstreet survey results

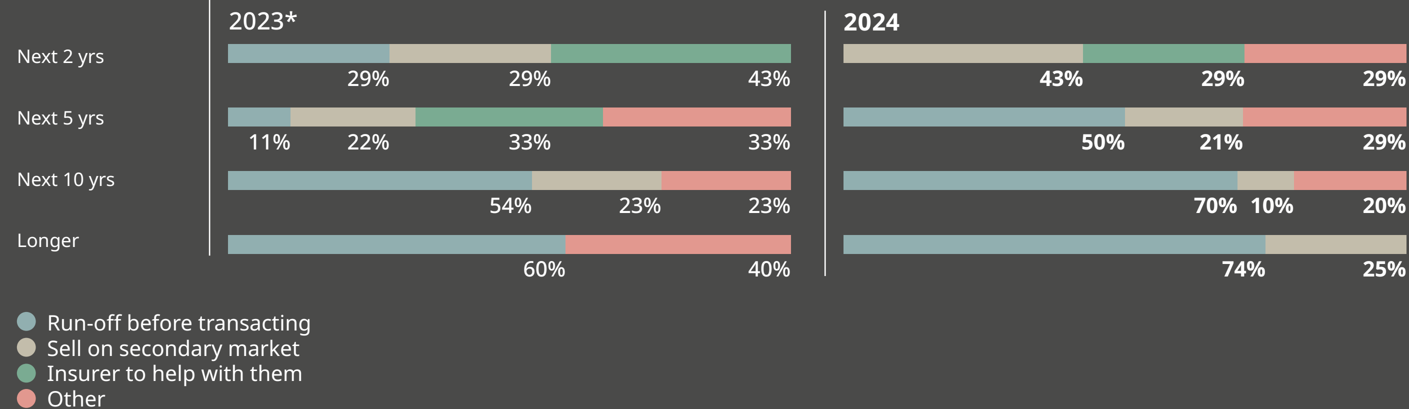
A mixed picture on illiquid holdings

60% of schemes targeting buy-out hold fewer than 10% illiquids in their portfolio and 41% do not have any illiquid exposure. However, the proportion of schemes with more than 10% of illiquids has increased. This is likely a result of the mini-budget crisis in 2022, with the resulting rise in interest rates leading to other assets reducing in relative size.



Naturally, time is a key factor that drives how a scheme will deal with their illiquids. For example, many of those that are at least 5 years away from their endgame will simply allow their illiquids to run-off before they transact.

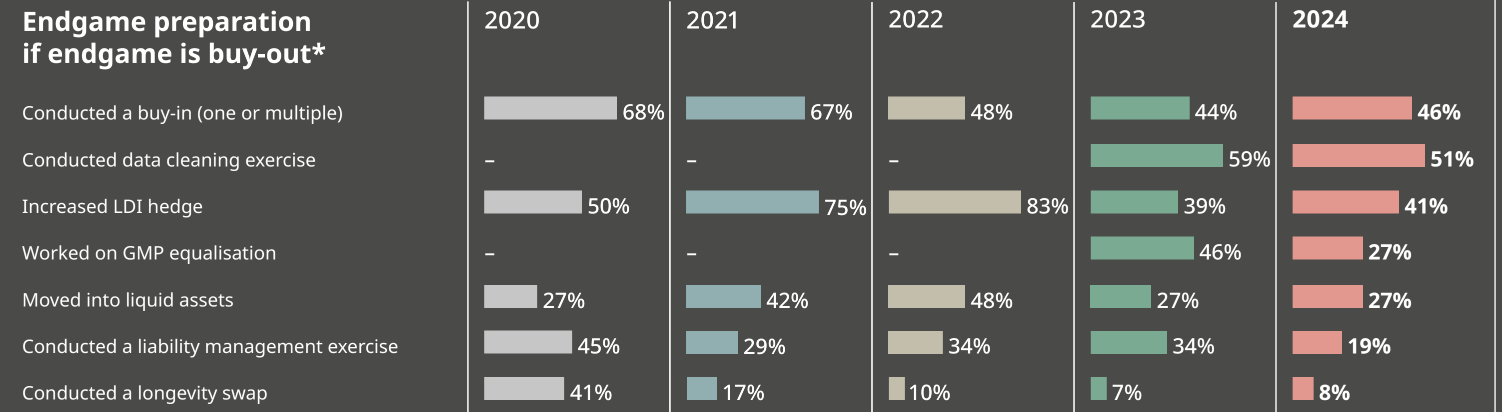
Meanwhile, 10% of those with less time to go but still overweight in illiquids will ask insurers to help them with this allocation, while 14% plan to sell them on the secondary market.



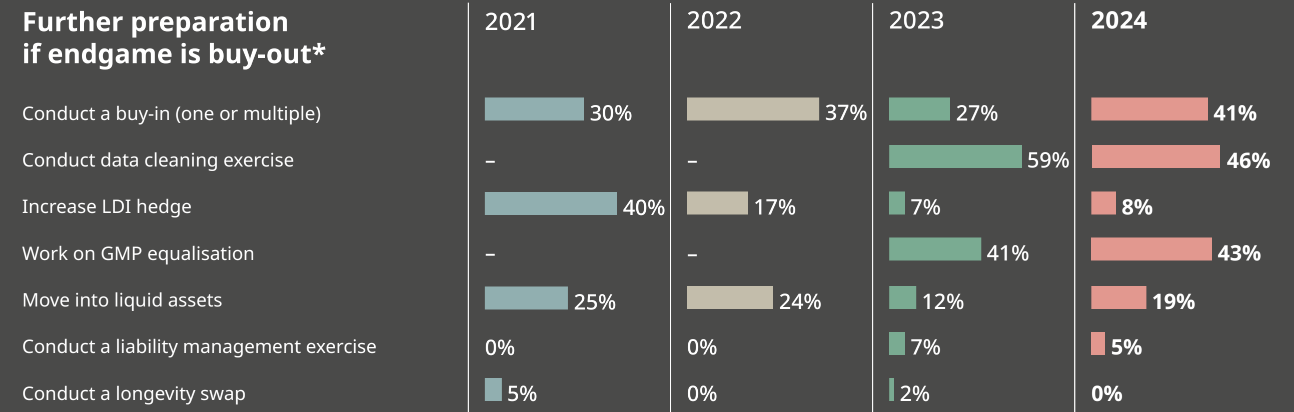
* The question about plans for dealing with illiquid assets was introduced in 2023.

Schemes targeting buy-out continue to prepare

Data cleansing and completing GMP equalisation work remain key priorities for those pursuing buy-out, highlighting their increased importance as the expected time to buy-out reduces. Many schemes on the road to buy-out have previously conducted a buy-in, with the focus now shifting to full buy-out.



* The answer options 'Conducted data cleaning exercise' and 'GMP equalisation' were added in 2023. The answer option 'Moved into liquid assets' was reworded from 'Moved into cashflow matching assets' in 2023.

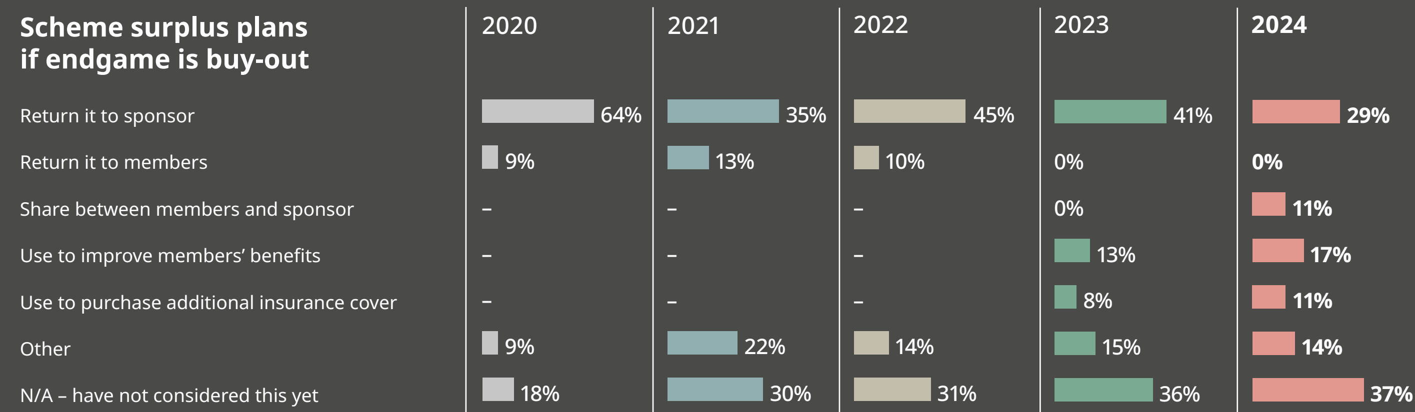


* The answer options 'A data cleaning exercise' and 'GMP equalisation' were added in 2023. The answer option 'Move into liquid assets' was reworded from 'Move into cashflow matching assets' in 2023.

mallowstreet survey results

Surplus brings another consideration for schemes

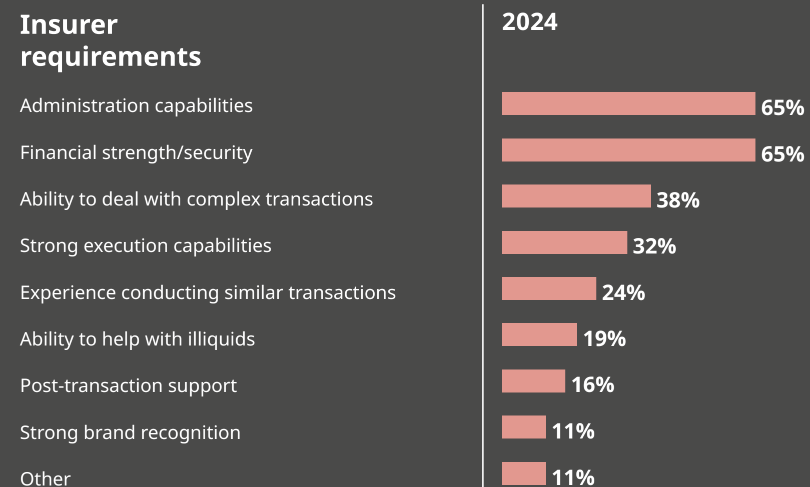
37% of schemes have yet to consider how they will deal with a surplus. For many, it could be a thorny issue: scheme rules can be vague, and there may be competing priorities between trustees and sponsors. As such many schemes may not fully plan until they are closer to buy-out and/or have more certainty on the expected level and treatment of surplus. Among those that have a plan in place, 29% expect to return the surplus to the sponsor while another 17% will use it to improve members' benefits.*



* The question format changed in 2023. Prior to then, the question did not contain the following answer choices: 'Share between members and sponsor', 'Use to improve members' benefits', 'Use to purchase additional insurance cover'. Additionally, from 2023 it has been possible to choose more than one answer.

Schemes targeting buy-out focus on insurer financial strength and administration

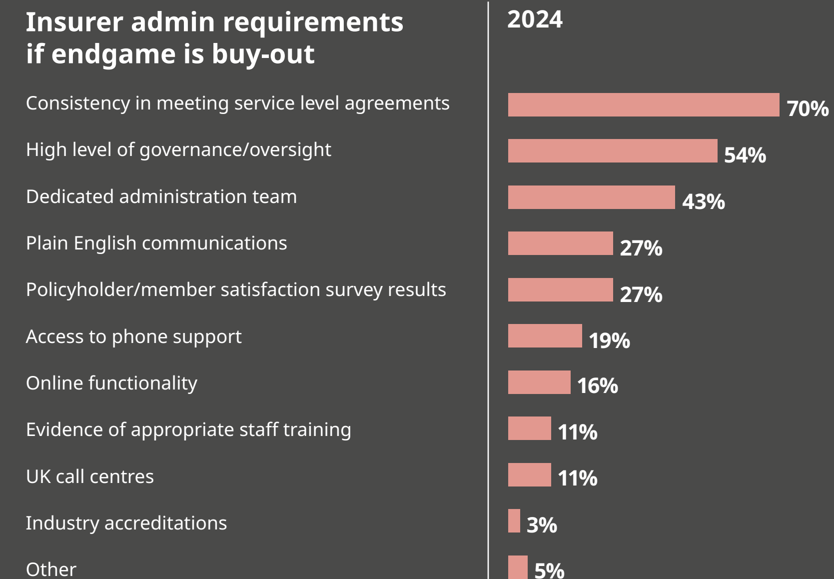
65% of schemes surveyed this year noted that financial strength and administrative capabilities are key requirements of their chosen insurer. With surpluses on the rise, schemes are more likely to consider other aspects of each insurer's offering.*



* This question was introduced in the 2024 survey.

Service levels and governance are key in assessing insurer adminstration

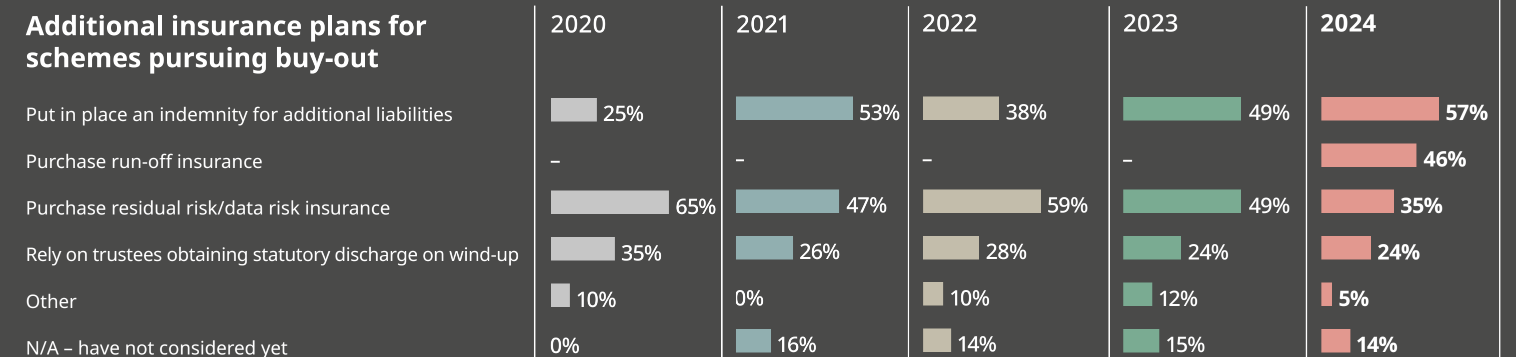
70% of schemes surveyed said consistency in meeting service level agreements was important in assessing insurers' administration requirements. Governance and oversight, and a dedicated administration team were also key requirements for schemes.*



* This question was introduced in the 2024 survey.

Schemes are increasingly considering alternatives to residual risk cover

The demand for residual risk insurance appears to have fallen, with schemes more likely to put in place an indemnity for additional liabilities (57%) and consider run-off insurance (46%). Another 24% of schemes plan to rely on trustees obtaining a statutory discharge on wind-up.*

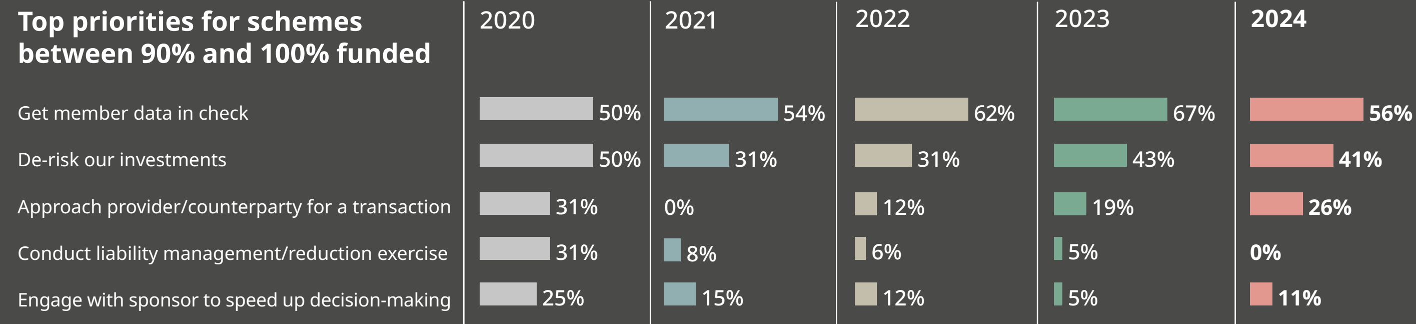


* 'Purchase run-off insurance' was added as an answer option in 2024.

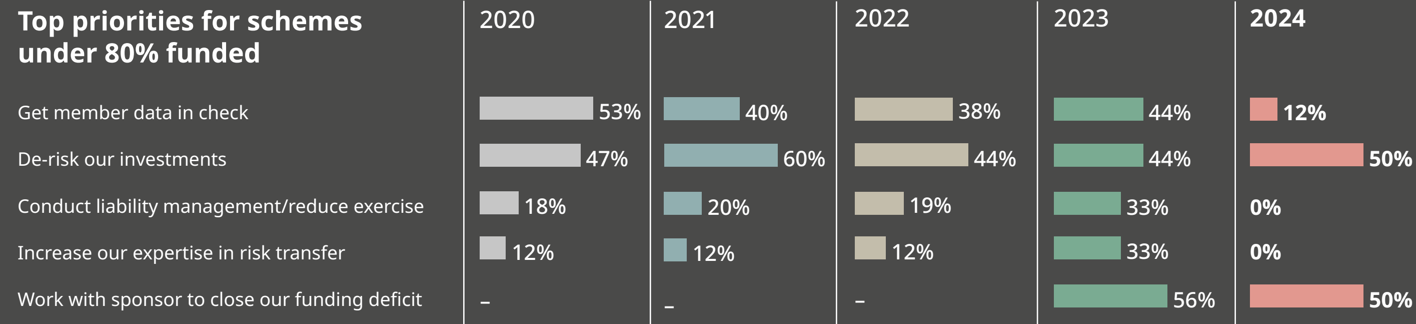
mallowstreet survey results

Well-funded schemes are prioritising member data and early insurer engagement

Those close to being fully funded continue to prioritise data preparation. There has been an uptick in those planning to approach an insurance provider for a transaction this year, suggesting increasing confidence in their preparedness.



Meanwhile, for underfunded schemes one of their main priorities across five years is de-risking their investments and, perhaps unsurprisingly, working with the sponsor to close their funding gap.*

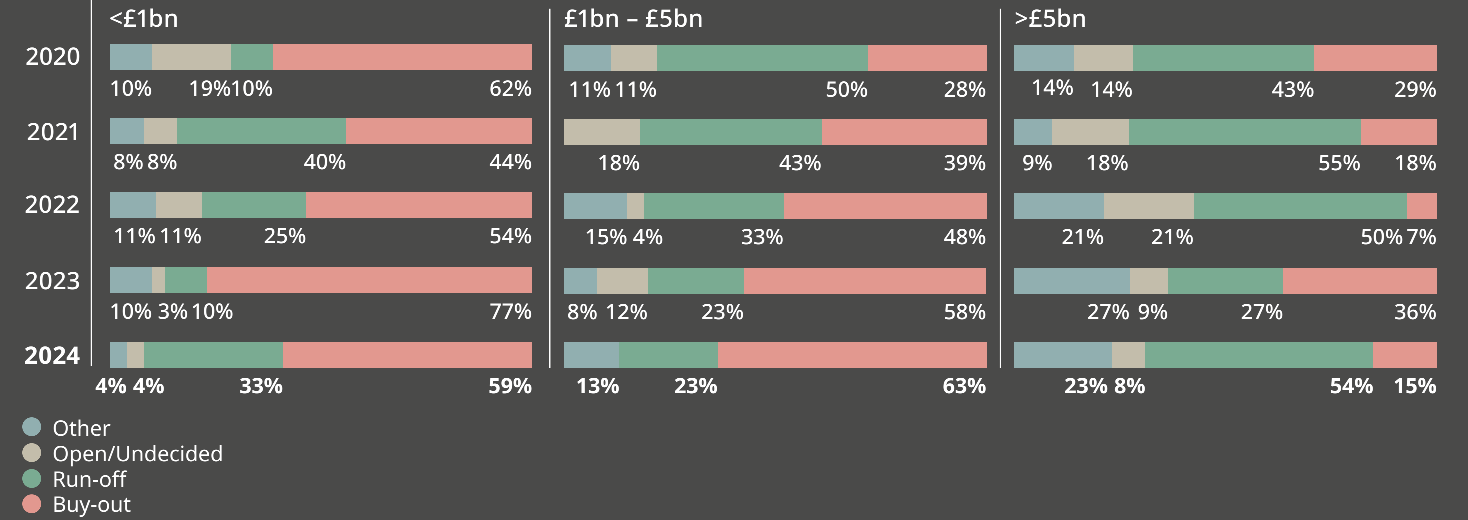


* 'Work with the sponsor to close our funding deficit' was added as an answer option in 2023.

Schemes below £5bn overwhelmingly favour buy-out

In comparison, just 15% of schemes above £5bn are targeting buy-out – down from 36% last year – with run-off more of a consideration for larger schemes.

Endgame plans by scheme size



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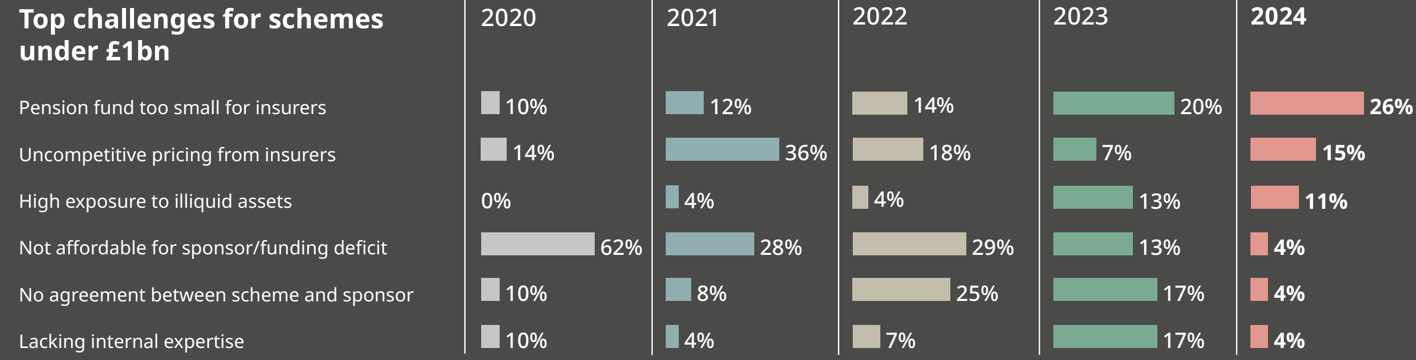
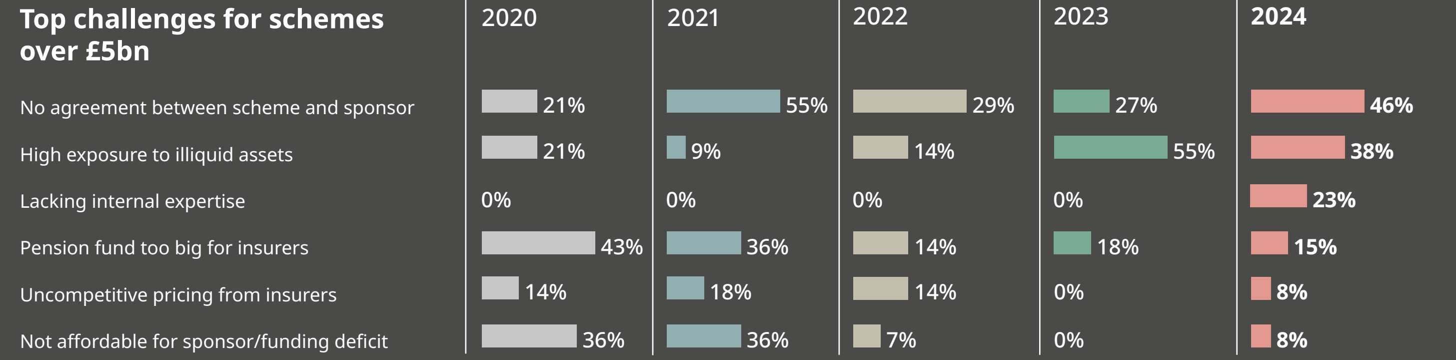
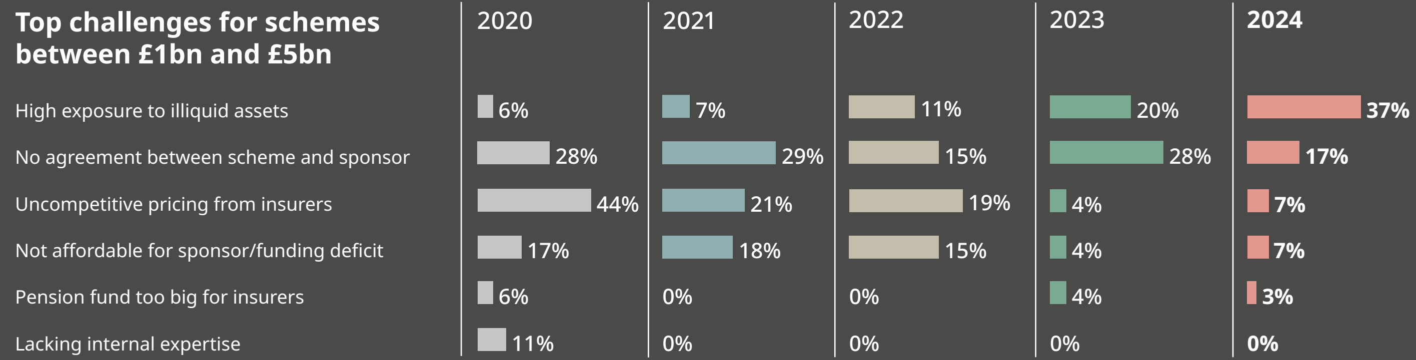
Despite concerns, smaller schemes can find a home in the insurance market

Schemes under £1bn cite their "smaller" size as their top challenge. However, in 2023, out of 226 bulk annuity transactions, 162 were under £100m in size, and 210 were less than £500m in size.





In comparison, 46% of schemes above £5bn say the lack of agreement with the sponsor is their biggest challenge. Encouragingly, the improvement in buy-out affordability for schemes over the last couple of years has been met with less concern that their scheme is too big for the insurance market. High exposure to illiquid assets is also a growing problem for this group and mid-sized schemes.



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

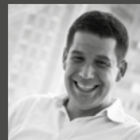
mallowstreet survey results:

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

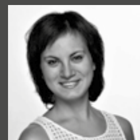
mallow street

mallowstreet is a members-only online community website, with a portfolio of educational in-person and digital events that it sits alongside. Both the website and events are tailored for professionals in the institutional pensions and insurance industry. We are accredited by the Pensions Management Institute and a certified B Corporation.

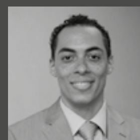
The results in this publication are based on 5 years of survey data collected between 2020 and 2024. This year’s survey included responses from trustees and decision makers representing 70 pension schemes. Key statistics on the participating schemes are detailed here.



Stuart Breyer
CEO

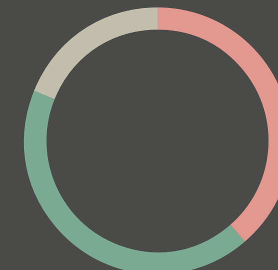


Ally Georgieva
Head of Insights



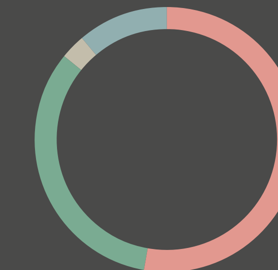
Ryan Daley
Senior Investment Researcher

By scheme size



Under £1bn	**39%** (27)
£1-5bn	**43%** (30)
Over £5bn	**19%** (13)

By endgame

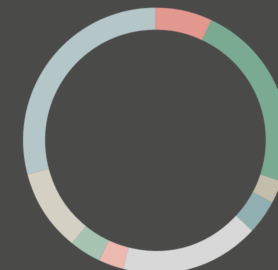


Buy-out	**53%** (37)
Run-off	**33%** (23)
Open/Undecided	**3%** (2)
Other	**11%** (8)

By time to endgame

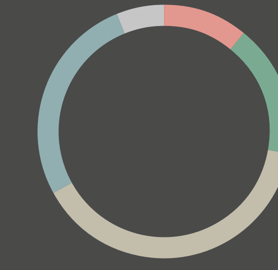
Next 2 yrs	**31%** (22)
Next 5 yrs	**34%** (24)
Next 10 yrs	**21%** (15)
Longer	**13%** (9)

By sponsor sector



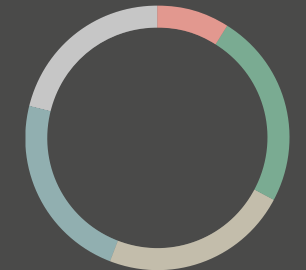
Construction	**7%** (5)
Finance/Banking	**23%** (16)
Healthcare	**3%** (2)
Information Technology	**4%** (3)
Manufacturing	**17%** (12)
Oil and Gas	**3%** (2)
Transport and Logistics	**4%** (3)
Wholesale Retail	**10%** (7)
Other	**29%** (20)

By funding level on buy-out basis



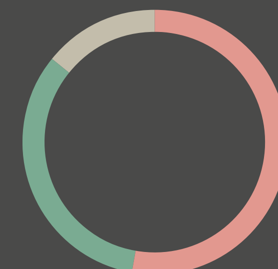
Under 80%	**11%** (8)
80% - 90%	**17%** (12)
90% - 100%	**39%** (27)
Over 100%	**27%** (19)
Other	**6%** (4)

By buy-out discount rate



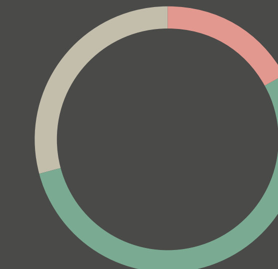
Gilts minus 1-50 bps	**9%** (6)
Gilts flat	**24%** (17)
Gilts plus 1-50 bps	**23%** (16)
Other	**23%** (16)
Unknown	**21%** (15)

By sponsor covenant



Strong	**53%** (37)
Tending to strong	**33%** (23)
Weaker	**14%** (10)

By pensioner liabilities



Under 40%	**17%** (12)
40 - 60%	**54%** (38)
Over 60%	**29%** (20)

J2B4

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***.
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.
Buyer's Report	A ***due diligence*** report on the scheme's legal documentation, prepared by a law firm acting for one or more insurers involved in the quotation process, on which the insurer(s) can rely.
Captive cells	These are cells that all sit within one cell company but with each cell having a separate legal identity which will be sufficient for it not to be impacted by the insolvency of another cell in the same cell company. Assets and liabilities are held separately between the cells. Often used to facilitate a longevity swap with a separate cell being used for each transaction.
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.

J2B4 JARGON BUSTER

Term	Explanation
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.
Cost of Capital Rate	A fixed figure used in the calculation of the ***risk margin***. In the UK version of ***Solvency II*** it is currently set at 4%, having been reduced from 6% on 31 December 2023 as part of the UK's ***Solvency II*** reform process.
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.
Deferred Premium	This is where part of the premium paid by the trustee to enter into the ***buy-in*** is deferred and is paid at a date later than when the ***buy-in*** is signed and the policy incepts/becomes live, usually by a set deadline.
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/DD	This normally includes a review of scheme data, governing documents and/or administration systems and processes to determine readiness for a transaction and inform the scope of any ***residual risk*** cover.
ESG	ESG covers environmental, social and governance issues (but consensus on details of the meaning can vary).
Exclusive broking process	This is where a trustee pre-selects one insurer and requests pricing only from that insurer.
Exclusivity	Where the trustee agrees to only negotiate with a certain insurer for a possible transaction. It will usually last for a limited time. There is no obligation to transact at the end of it. Exclusivity may be documented in an exclusivity letter and is often provided as part of the insurer agreeing to a ***price lock***.
Experience data	The data the trustee holds about the 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.

J2B4 JARGON BUSTER

Term	Explanation
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.
Fundamental Spread	This is the allowance for risks of default and credit downgrade retained by an insurer on its portfolio of investments and is used as part of the insurer's ***matching adjustment*** calculations.
Funded Reinsurance	A reinsurance agreement between an insurer and ***reinsurer*** to cover all, or part, of member benefits provided for under the insurer's ***bulk annuity*** contract. The insurer pays a single premium to the ***reinsurer*** and collateral is typically provided to the insurer by the ***reinsurer***. The ***reinsurer*** takes on both longevity and assets risk.
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***.
Highly Predictable (in the context of Solvency UK)	***Solvency II*** currently requires that insurers only include assets in their ***matching adjustment portfolios*** if those assets have 'fixed' cash flows. However, as part of the ***Solvency UK*** reforms, the range of assets that are eligible for ***matching adjustment*** treatment will be expanded also to include assets with 'highly predictable' cash flows. Although this will allow some assets to be included where their cash flows can be changed, those assets will need to fall within the ***PRA's*** requirements for 'highly predictable' assets: the contractual terms of the asset must set out a bounded range of variability, in terms of the timing and amount of the cash flows, and any failure to meet those terms must be a default. In addition, the ***PRA*** has said that assets with highly predictable cash flows will only be allowed to generate up to 10% of the total ***matching adjustment*** benefit of the ***matching adjustment portfolio***.
Illiquid Assets	Pension scheme assets that cannot be easily sold or realised (without a substantial loss in value).
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.

J2B4 JARGON BUSTER

Term	Explanation
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***.
Key Performance Indicators	How performance by an administrator providing pension administration services to a trustee and/or an insurer is measured.
Longevity	How long members live for.
Longevity swap	An insurance policy similar to a ***buy-in*** but the only risk the insurance policy covers is ***longevity***. It covers the risk of members living longer than expected. The survival of dependants is usually covered as well.
Longevity swap novation/ conversion	This is where a ***longevity swap*** is turned into a ***buy-in*** with the ***reinsurer*** counterparty in the ***longevity swap*** providing the ***reinsurance*** to the ***buy-in*** insurer.
Marital status data	This is data that confirms the member's marital status that can be useful for insurers and ***reinsurers*** when pricing a transaction.
Marital status survey	A survey a trustee may undertake of its scheme's members to get details of members' marital status. This can be useful for insurers and ***reinsurers*** when pricing a transaction.
Monoline insurer	An insurer that only provides a certain type of insurance, such as ***bulk annuity*** insurance.
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 matches 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").

J2B4 JARGON BUSTER

Term	Explanation
Part VII Transfer	This is a court-approved regulatory process for an insurer to transfer some or all of its 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***.
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***.

J2B4 JARGON BUSTER

Term	Explanation
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.
Seller's Report	This is a report of the results of the ***vendor due diligence*** a trustee has carried out on the scheme ahead of approaching the market. This usually is shared with insurers on a non-reliance basis.
Service Level Agreement	An between trustees and/or insurers with their administrator to set contractual timescales for services to be carried out.
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 the UK's main legal framework governing how insurers carry out their business. It is based on an EU directive of the same name, although the UK and EU regimes nowadays exist separately. The UK government and the PRA have made and are continuing to make changes to UK Solvency II: the UK's amended version tends to be known a "Solvency UK" and as UK Solvency II is diverging from EU Solvency II, that is the more accurate term to use in the UK. Solvency II imposes 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.
Solvency II capital requirements/ SCR/Regulatory Capital	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.
Solvency UK	Solvency II is undergoing a series of reforms, in part to optimise it for the UK market. Once that process is complete, Solvency II will eventually be known as 'Solvency UK'.
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.
Surplus	Where a scheme's assets (on a given actuarial valuation basis) exceed its liabilities. (The existence or amount of surplus will vary depending on the relevant actuarial basis being used.) Following a full ***buy-in*** or ***buyout***, surplus is the amount of scheme assets remaining, once funds for remaining scheme expenses have been set aside.
Technical Provisions	These represent the amount that an insurer has determined is required to fulfil its insurance obligations over the lifetime of its insurance contracts. An insurer must calculate its technical provisions as required by the ***PRA***'s Rules: the value of ***technical provisions*** must be equal to the sum of a ***best estimate*** and a ***risk margin*** which in turn must be calculated in accordance with the ***PRA***'s Rules.
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***.
Top up DD	This is ***DD*** an insurer may carry out on a scheme in addition to the legal ***DD*** schemes may have carried out before approaching the market (whether that resulted in a ***buyer's*** or ***seller's report*** being produced).

J2B4 JARGON BUSTER

Term	Explanation
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 a trustee may commission (itself or from a third party) of a scheme, its data and processes in preparation for a transaction. The trustee may choose to share the results with an insurer or ***reinsurer*** via a ***seller's report*** (either on a reliance or non-reliance basis). An insurer or ***reinsurer*** may choose to carry out ***top-up DD***.
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 17 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 recently spoke at the SPP webinar on "Preparing for a Bulk Annuity Transaction" in May 2024 alongside representatives from Rothesay, Aviva and LCP.

Phil Goss
Linklaters

Phil is a Partner in Linklaters' pensions team, advising trustees, corporates and insurers on all areas of pensions law, including on a range of complex, large-scale risk transfer transactions, including residual risk and PPF+ trades. Phil is currently advising various clients on endgame strategy, planning and negotiations.

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); 3i Group Pension Plan (£650m buy-in with L&G); Co-operative Pension Scheme (five transactions with two insurers totalling c.£6.76bn of liabilities); and MMC UK Pension Fund (£2.2bn longevity swap with Munich Re).

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

Katie Overton

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

Stephen Longfellow

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

Will Ranson-Smith

will.ranson-smith@rothesay.com
Direct dial: +44 (0)20 7770 5464
Mobile: +44 (0)7766 046 433

Róisín O'Shea

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

Cleo Taylor Smith

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

Simon Bramwell

simon.bramwell@rothesay.com
Direct dial: +44 (0)7970 397 550

Phil Alexander

phil.alexander@rothesay.com
Direct dial: +44 (0)20 7770 5479
Mobile: +44 (0)7392 989 119

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Welcome to the endgame

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Visit us at emperor.works

Rothesay
The Post Building
100 Museum Street
London
WC1A 1PB

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