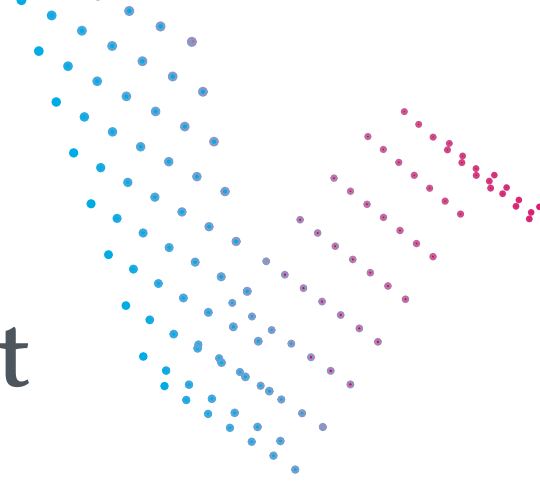
HYMANS ROBERTSON



Excellence in buy-out

Many defined benefit (DB) pension schemes are now approaching the point where they can plan, should they wish, to insure their liabilities and wind up their scheme.

In this publication we ask:

- What role should the company sponsor play?
- What does a great buy-out process look like?

We're going to assume that the scheme in question has gone through a thorough advice process to conclude buy-out is the right way forward for them.

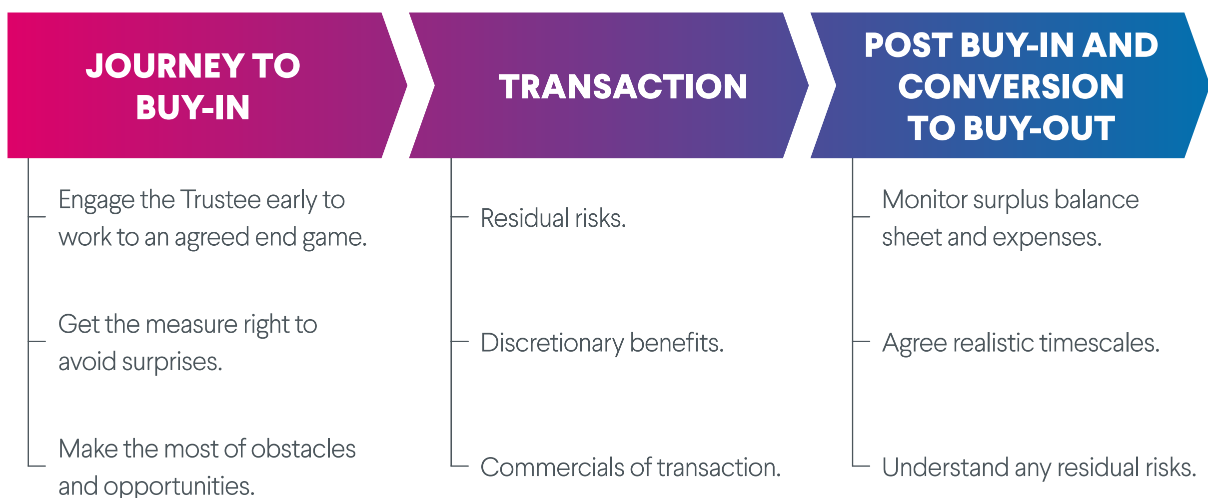
Check out our Excellence in endgames insight hub for lots of great content on how to approach that discussion and consider the full spectrum of endgame options.

Is there a role for the sponsor?

Yes, absolutely. An engaged sponsor is in all parties' interest, as we explain below. From the company's perspective, this is a large, complex financial project (involving millions or even billions of pounds) that is going to run over many years. If anything goes off track it is the company that will have to meet the cost of getting things back on track. Nowhere else in a business would a company leave that scale of risk to a third party with no collaborative oversight.

Buy-outs can also gain media attention - especially if there ends up being member unrest. Companies will be on the backfoot if this happens and they have not been close to the process. More positively, as we discuss further on, there are many stages in the process where close collaboration between the company and the pension scheme trustees can make a positive difference to the outcome.

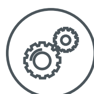
The three stages to buy-out



Run-up to the insurer transaction

In this first phase, the scheme needs to accurately track its funding progression and timeframes to being able to afford an insurance transaction. Over this period the scheme needs to get 'insurer ready' and needs to lay the foundations for efficiently winding up.

Some key areas that the company and trustees need to collaborate closely on include:



The technical aspects of how the scheme is tracking buy-out funding levels.

Get this wrong and there is a real risk of poor decision-making, for example, risk of over-funding or not moving forward on operational issues quickly enough to be ready to transact at the best opportunity.

Traditional funding approaches, such as "gilts plus" discount rates, may be suitable for ongoing funding discussions but do not track insurers' pricing well. Actual insurer pricing is influenced by a number of factors, including asset availability, reinsurance pricing, and supply and demand dynamics. It is important the monitoring being used is well understood by all parties and is fit for purpose.

The type and extent of due diligence and data cleaning that is carried out before the scheme engages with insurers.

As we'll see when discussing the final wind-up stage, there is an important link between the level of residual risk exposure that remains after the buy-in and the extent of investigations pre-insurance. It is really important that the company and trustees fully understand this issue and make a joint decision on how much preparatory work to do before the insurer transaction.

The work required to prepare for a buy-in transaction should not be underestimated– having an agreed plan and starting the work early will help to make the most of pricing opportunities and mitigate the risk of a trapped surplus.

The insurance transaction

The insurance market is currently very busy, and this is likely to continue to be the case. Insurers are looking for well-prepared schemes that give confidence they are serious about transacting. The more credible the scheme position, the more likely good insurer engagement and a successful outcome.

Sponsors have a key role to play, for example:

1. Demonstrating they are engaged in the process, are pulling in the same direction as the trustees and are not likely to get cold feet at the last minute (one of insurers' biggest concerns).
2. There are examples where an existing relationship between the sponsor and the insurer has led to a better deal, as the insurer is keen to make an investment in the wider relationship.
3. Where a complex benefit needs to be insured, for example some form of discretionary benefit, care is needed to ensure the final approach does not lead to member unrest or unacceptable risk for the company. That risk can be reputational, via poor media coverage, or financial via future member claims. A satisfactory outcome can only be achieved by the trustees and company fully exploring the options and agreeing a joint position.
4. The balance between what risks will ideally be insured and which will remain post buy-out needs to be agreed at this stage. This will require the trustees and company to get comfortable on the overall strategy for managing the full range of scheme risks post buy-out. If this does not happen, there is a good chance the insurer transaction will complete and then the buy-out will be de-railed by the question of managing residual risks.

Schemes can attract better pricing by having a unified trustee, supported by an engaged company, able to demonstrate the robust process it's been through to bring its scheme to market.

Converting to buy-out

The final stage of the process is to complete the work on scheme data necessary to convert the buy in contract to a series of individual annuity contracts between the insurer and each individual member, breaking the link to the scheme. This process can lead to benefit adjustments to members' annuities as final complexities with the benefit design can be resolved, including completing GMP equalisation.

In tandem with this, the various legal requirements that must be met before a trust can be wound up need to be worked through.

All the above can take many years to work through and in addition to being a very detailed process, involving considerable operational spend - issues can be identified that require decisions to be made impacting the costs and risks faced by the company.

By this stage, there will be clarity on the range of risks remaining that have not been mitigated by insurance and a decision will be needed on how these remaining risks are to be managed, including the role of company indemnities. If the process has been well run, this will be well-trodden ground that has been discussed and resolved prior to the insurance transaction.

Conclusion

A scheme buy-out does not have to be a painful process, but it can be if badly managed and can result in higher costs, additional risks and poor member experience. To avoid this, companies and trustees need to work together throughout the process to achieve an optimal outcome for all stakeholders.

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