SLAUGHTER AND MAY/

PENSIONS DERISKING: PLANNING FOR AN ACCELERATED JOURNEY

CAPITAL FLOWS
Part of the Horizon Scanning series

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Levels of activity in the UK pensions derisking market in 2023 are on course to eclipse previous records, both in deal size and overall volumes (the previous record being £43.9bn in 2019). Projections are that market volumes could exceed £60bn in 2024 and continue to rise. This reflects trends in other jurisdictions including the US, which has also seen record volumes of pension risk transfer in recent years.

Activity in the UK market has also been supported by US and Canadian groups seeking to insure the liabilities of their UK defined benefit pension schemes (as we have seen in our work on transactions involving Intact and Walgreens Boots), which in some cases can be viewed as paving the way for potential M&A activity.

Dramatic improvement in scheme funding levels, in the wake of the 2022 mini-budget and subsequent gilt crisis, mean that many UK defined benefit pension schemes are now fully funded or above a funding level of 90% on a "buy-out" basis.

Scheme trustees may now intend to transfer risks to an insurer on an accelerated timeline, compared to previous journey planning. A well-advised corporate sponsor of a pension scheme should consider taking an active role in this process and appointing its own legal and actuarial advisers. This will help to ensure that it can shape the process and outcome, with its interests being reflected in the deal shape and terms, rather than leaving the Trustee and its advisers to progress a potential transaction independently.

By doing so the sponsor can overcome what are otherwise two material unmitigated risks. Firstly, the Trustee shaping and negotiating the asset size and terms solo, with the sponsor continuing to have the contingent funding liability for the scheme. Secondly, the governance and analysis of the underlying risks and their mitigation being contracted out to the Trustee board. Involvement from an early stage, with the governance that the sponsor would normally bring to bear on material asset acquisitions (through its board and treasury, legal and other functions), will help to ensure that the sponsor's interests are taken into account.

INSURING SCHEME RISKS AND SPONSOR'S ROLE

A corporate sponsor of a defined benefit pension scheme needs to consider whether its objectives are truly aligned with the trustee's, both in terms of whether, when and how much to insure and the process, pricing and terms for the insurance transaction.

A large derisking project is akin to major M&A. The trustee is the transferor of assets and liabilities pursuant to a 'buy-in' policy, selecting a preferred insurer with which to transact from a competitive process and agreeing price and other terms for the deal. Once the premium is paid, the trustee has no assets beyond any contingency reserve established for the scheme, so the Sponsor is contingently liable for the consequences of these terms. This includes liability if the insurer defaults prior to issuing individual annuity policies to scheme members (known as 'buy-out'), as well as for any uninsured unknown liabilities that emerge in the future.

A sponsor will also need to ensure that the trustee's plans align with its own objectives, including on residual risks, the accounting impact and the approach to any surplus in the scheme, which may be trapped if the sponsor continues to make contributions after buy-in. From a governance and reputational perspective, the sponsor needs to not only be aware of, and support, these consequences, but also to influence their outcome by being front and centre of a joint working approach from the outset of the project, rather than becoming engaged at a later stage when the shape of the transaction is already formed.

"BIG BANG" APPROACH

RSA/Intact case study

- Single buy-in covered **40,000 members** and **c.£6.5 billion of liabilities** across two RSA schemes (February 2023)
- Pensions Insurance Corporation selected following competitive process
- c.£500m contribution from Intact
- Significant issues of timing and complexity, including structure to accommodate existing longevity and asset swaps and illiquid assets
- Sponsor-led process, working collaboratively with both trustees and their advisers to agree insurer-facing position

Key features of a "big bang" process

- Focus and engagement by principals akin to a major M&A process on a similar timeline
- Maximises competitive tension pre-exclusivity
- More flexibility on very large deals to negotiate terms beyond what is "market"
- Accelerated timetable to capitalise on market pricing windows
- Commitment of resources (internal and external) necessary to achieve this
- Collaborative approach required to develop and test innovative solutions rapidly

STRATEGIC PARTNERSHIP APPROACH

Tata Steel UK case study

- Four buy-ins under umbrella terms took cover to **c.£7.5 billion of liabilities** and **c.67,000 members** (Nov 2021 to May 2023)
- Coordination between insurer, trustee and sponsor throughout period to optimise pricing, asset and data preparation, transitioning investments and due diligence
- Scheme's investment management transferred to insurer's in-house asset manager prior to full insurance
- Sponsor and advisers fully engaged in negotiations throughout to ensure a satisfactory outcome for the corporate

Key features of a strategic partnership

- Soft/non-binding commitments from insurer to facilitate future transactions
- Often alongside umbrella terms / tranches, but could be used for single large buy-in
- Prioritised within insurer's business plan, (e.g. sourcing best assets, accepting illiquid scheme assets, bespoke terms)
- Increased transaction readiness, resources and transparency from the insurer
- Requires sufficiently strong relationship with insurer and support from advisers to mitigate reduction in competitive tension

Key things to manage for derisking transactions with very large pension schemes

- Illiquid assets of a scheme (e.g. property, derivatives) – insurer's ability to accept these assets and scheme's ability and optionality to maximise their value
- Existing scheme arrangements (e.g. insurance arrangements, asset swaps)
- Appetite for and availability of certain deal terms (e.g. residual risks cover, security from termination rights/collateral, deferred premium)
- Insurer ability to transition scheme assets / source sufficient assets and reinsurance capacity
- Regulatory engagement/scrutiny for insurers on very large deals
- Right-sizing internal and advisory teams, including to facilitate insurer due diligence process
- Governance, preparedness and managing expectations – including sponsor/trustee dynamics

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