Hogan Lovells

Defined benefit pensions: approaching the end game?

Hogan Lovells Pension Team

23 November 2022

Speaking today

Claire Southern
Partner, London
Pensions

Duncan Buchanan
Partner, London
Pensions

Jonathan Russell
Partner, London
Corporate Insurance

Charlotte Yeates
Senior Associate, London
Pensions

Overview of the session

- Potential destinations for pensions schemes . . .
- Preparing for buy-in
- From buy-in to buy-out
- Protection for members in buy-out
- Ensuring trustees are properly protected!

Possible destinations

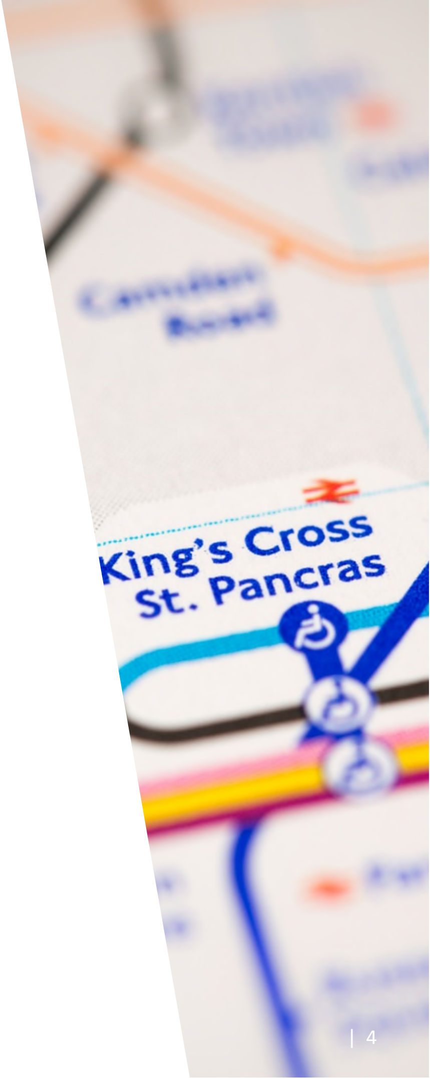
Buy-in followed by a buy-out and wind-up

Low dependency basis and pay pensions as fall due

Scheme merger

Transfer to superfund

Pension Protection Fund!



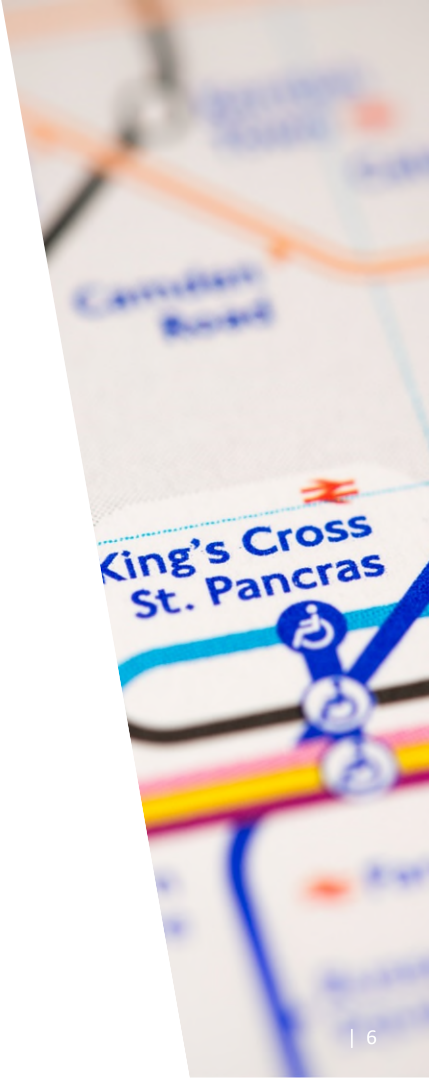
Possible destinations

What is buy-in?

What is buy-out?

What is a buy-in?

- Trustee uses the assets in the scheme to purchase an insurance policy where the insurer assumes responsibility for all the benefits under the scheme
- The insurer pays to the scheme each month exactly what the scheme needs to pay to its members – no matter what inflation does or how long the pensioner members live etc
- In this way the trustee holds an asset that perfectly matches its liabilities
- The member has the benefit of both the insurer covenant and the employer covenant!

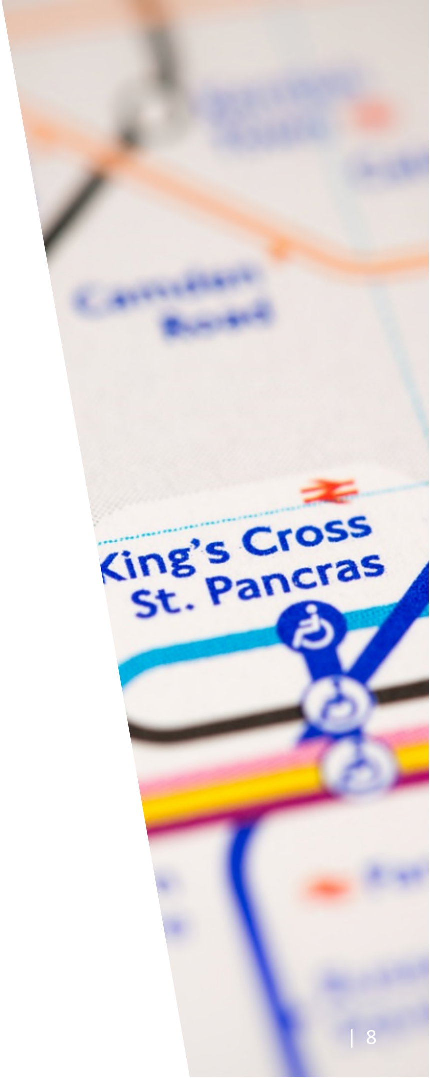


What is a buy-out?

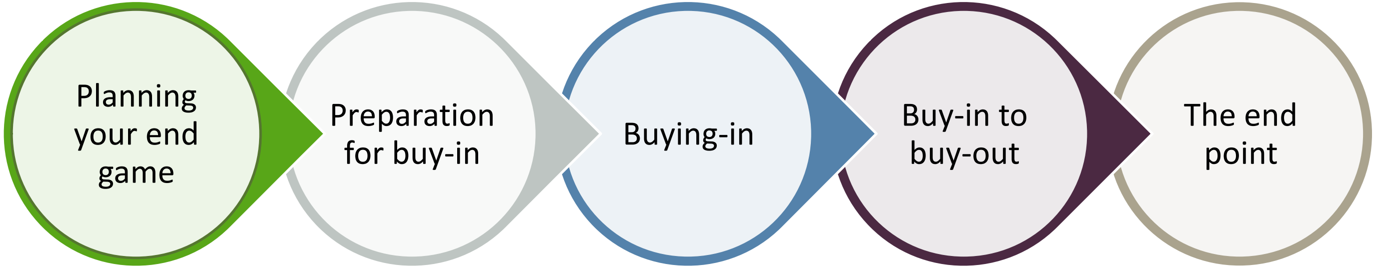
- In theory trustees could hold a buy-in contract for ever
- But, in practice, a buy-in usually ends with a buy-out
- This is where a winding-up of the scheme is triggered – usually by the employer
- And the buy-in contract held by the trustee is shattered into individual policies which are transferred to each individual member
- The member is now relying on the insurer covenant and the scheme completes wind-up and is no more!

What a buy-in and buy-out offers . . .

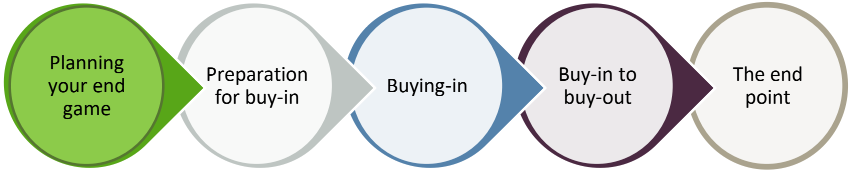
- Later session will cover this in detail . . .
- Buy-in and buy-out offers trustees and members the opportunity to have their benefits guaranteed by an insurance company
- Generally seen as a positive for members (and by extension trustees) – but it also means that the employer no longer has a liability to fund the scheme



The journey through buy-in to buy-out



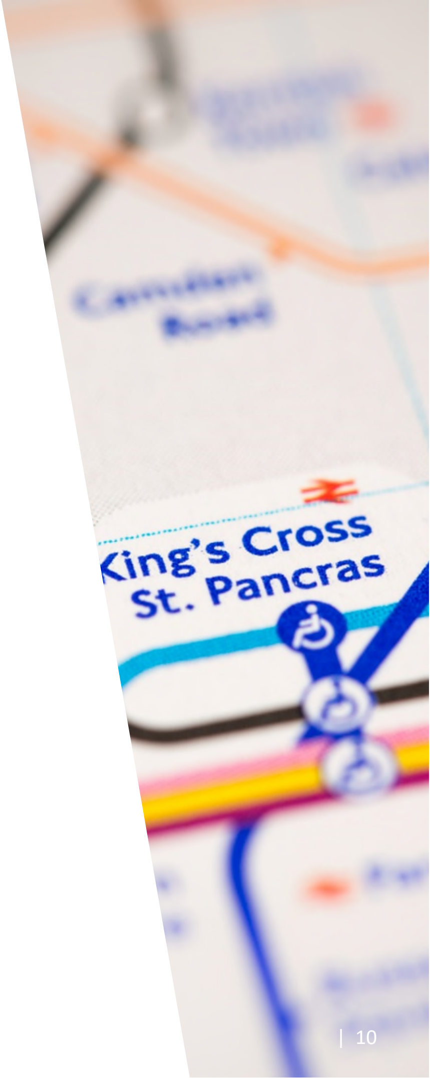
Key issues in the journey



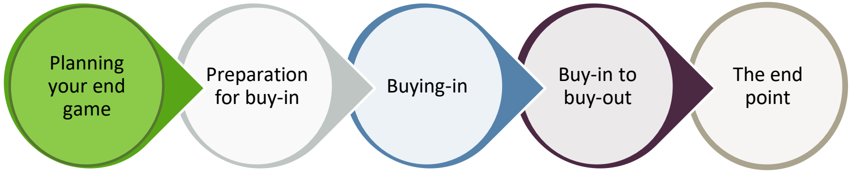
Some critical questions to ask before you start the journey

Investments:

- Is the scheme invested appropriately for a buy-in/buy-out scenario?
- If not, can changes be made and over what timescale? Factor in requirements for collateral calls if scheme is hedged!
- Don’t forget the Statement of Investment Principles . . .



Key issues in the journey

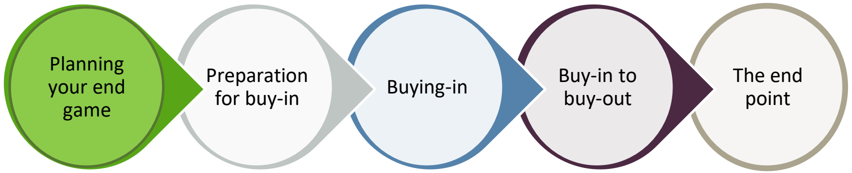


Some critical questions to ask before you start the journey

Company support and role:

- Is the employer supportive of the move? Difficult to get insurer engagement without support of the employer!
- Is the employer willing to contribute additional funds if necessary?
- Would the employer like to be part of the process – a working group is quite common with employer representation?

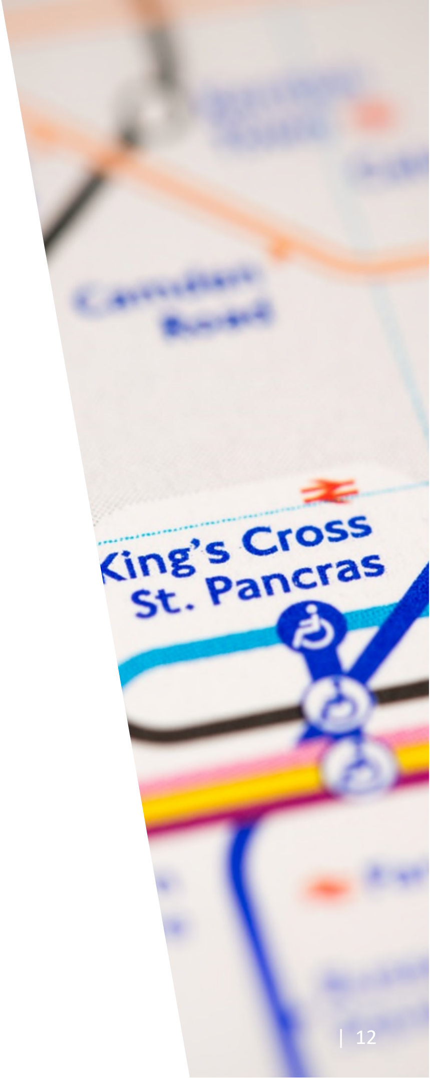
Key issues in the journey



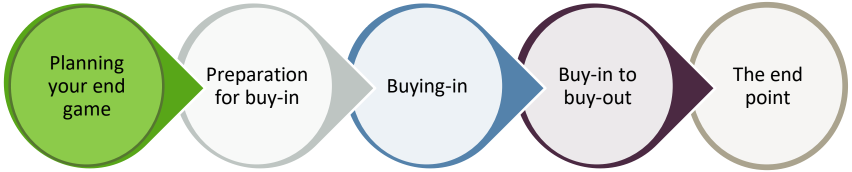
Some critical questions to ask before you start the journey

Surplus:

- Is there likely to be a surplus in the scheme?
- If so, who “owns” it? Employer? Members? Discretion of the trustee?
- Is it possible that there is a “deal” to be done with the employer on the surplus? Perhaps an immediate benefit improvement as part of the buy-in? Can the surplus be used to cover expenses – of the buy-in and going forward?



Key issues in the journey

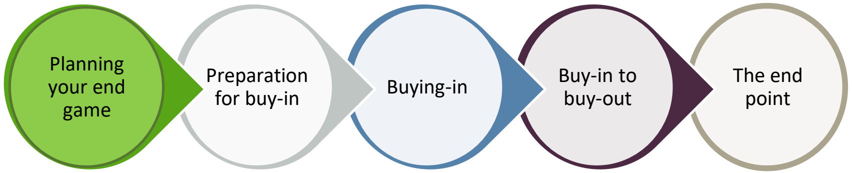


Some critical questions to ask before you start the journey

Powers to defer wind-up:

- Does the employer want the trustee to agree that the scheme will be wound-up rather than be run on?
- Is the trustee comfortable with this? Perhaps concerns about the administration by the insurer at buy-out?

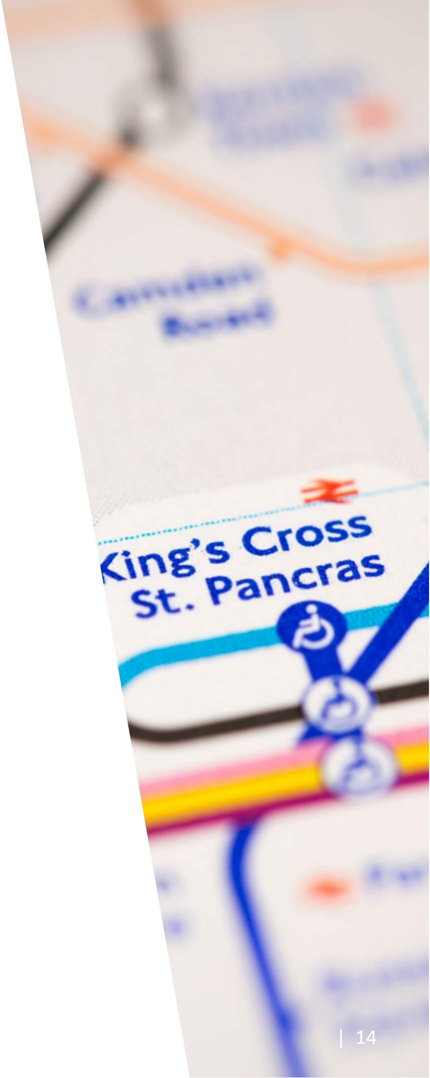
Key issues in the journey



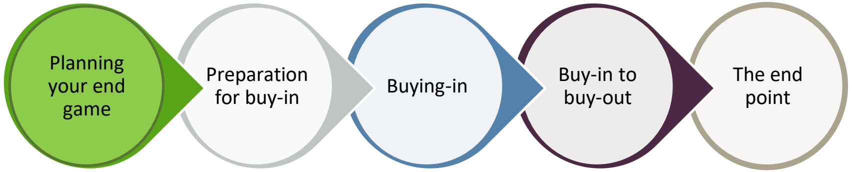
Some critical questions to ask before you start the journey

Residual risk cover, run-off insurance and additional indemnities:

- These are all ways of protecting trustees once the scheme has wound up
- Later session will cover these in detail . . .
- If trustees know they will want these – the costs need to be factored in – and a discussion needs to be had with the employer upfront



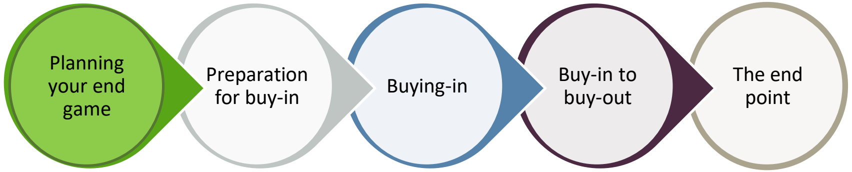
Key issues in the journey



Some critical questions to ask before you start the journey

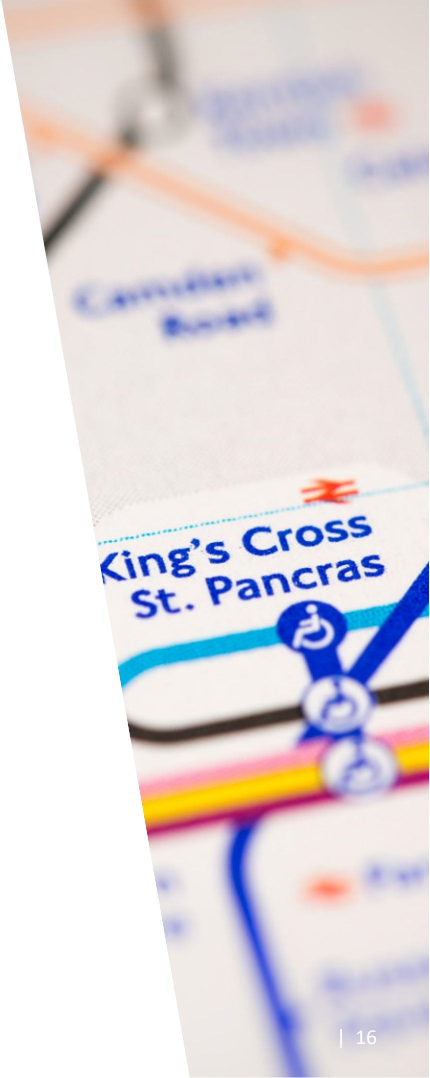
Consider bringing these issues together in an agreement between the trustee and employer early on!

Key issues in the journey

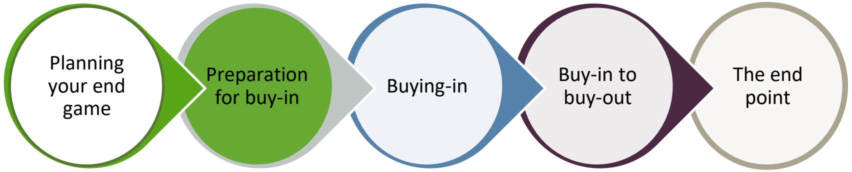


And some more practical questions . . .

- **Resources:** do you have the right internal and external resources to undertake a transaction? Actuary, lawyers, administrators, investment advisers, specialist bulk annuity consultants . . .
- **Data and benefits:** is your scheme data robust enough to undertake a transaction?



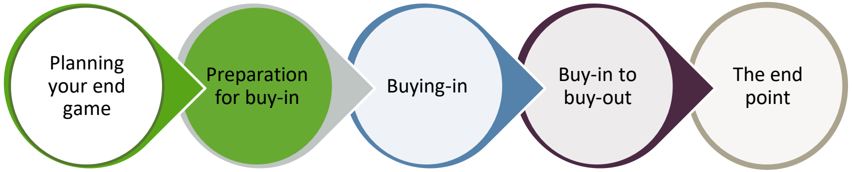
Key issues in the journey



Selecting your provider . . .

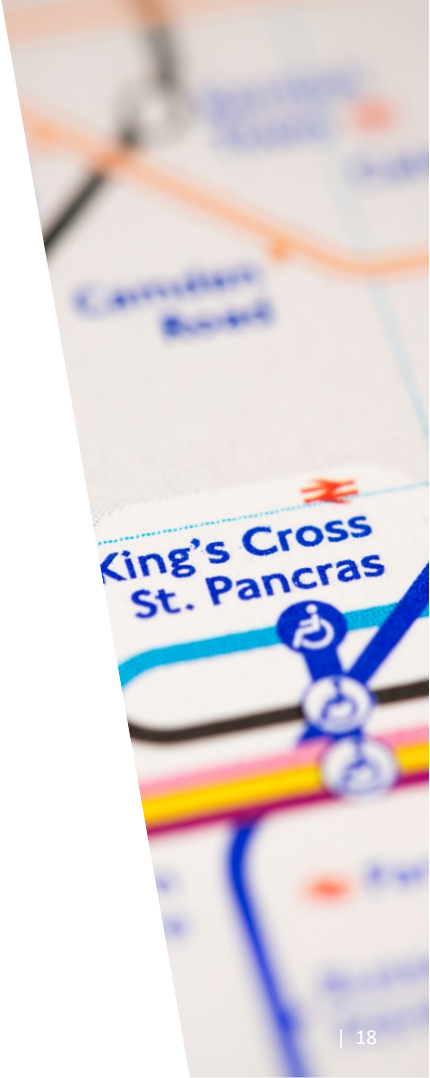
- Competitive tender process with RFP – usually undertaken by specialist annuity consultant
- Long list and short list
- Trustee versus employer perspective . . . cost, security, member experience, brand, member response . . .
- Commitment on contractual terms
- Insurers expect some level of "squeeze"!

Key issues in the journey



Benefit specifications and codifying discretions . . .

- Need to provide the insurer with a clear summary of the benefits payable to all members – tables drawn up to do this
- Also need to "codify" discretions – table drawn up
- Common issues include:
  - All members administered by latest Trust Deed and Rules
  - Insurer desire for simplicity versus mirroring exact legal entitlement
  - Lots of insurer questions



Key issues in the journey

Planning your end game → Preparation for buy-in → Buying-in → Buy-in to buy-out → The end point

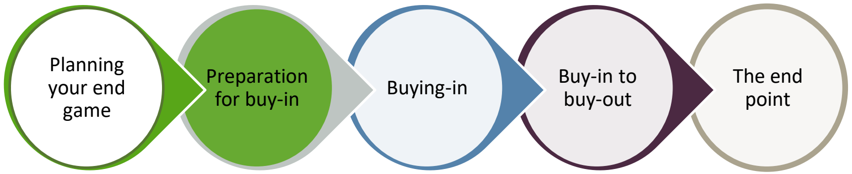
BENEFIT SPECIFICATION

The Example Pension Scheme (the "Scheme")

1. **BENEFIT TERMS FOR DEFERRED MEMBERS**

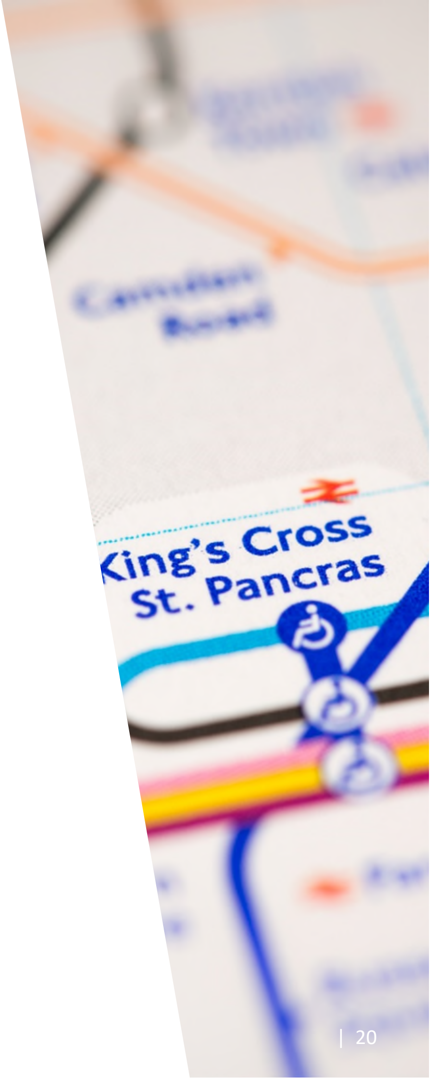
GMP Revaluation	*Deed of Amendment 23 June 2018, 2.4*	GMP accrued to the Relevant Date increased for each tax year after that date up to and including the last complete tax year before State Pension Age or death, by the rate specified in regulations under section 16(3) Pension Schemes Act 1993. If the Relevant Date falls after 5 April 2016, Earnings factors for each tax year in Contracted-Out Membership will be increased in respect of the period before the last day of pensionable service in accordance with the last order made under s.148 Social Security Administration Act 1992 to come into force before that date. **"Relevant Date"** means: • if Pensionable Service ends before 6 April 2016, the last day of Contracted-out Membership; or • if Pensionable Service ends after 5 April 2016, the last day of Pensionable Service.
Deferred Pension	*Rule 13.1 (Deed of Amendment 23 June 2018, Clause 3.2)*	Formula Pension subject to Revaluation Requirements. Pension is payable from NRD.
Early retirement	*Rule 13.2 (Deed of Amendment 22 November 2006 Clause 5, Appendix 6)*	Member must have reached Minimum Pension Age or ill-health condition met (unable to carry on Member's occupation and ceased to work)
Late payment of deferred pension	*Rule 13.3*	Member (with Trustee consent) may defer pension until the later of i) 75th birthday or ii) ceasing to be in employment. If the Earnings Cap applies, may defer until 75th birthday. Member entitled to deferred pension plus a late retirement increase as determined by the Trustee in consultation with the Actuary.

Key issues in the journey

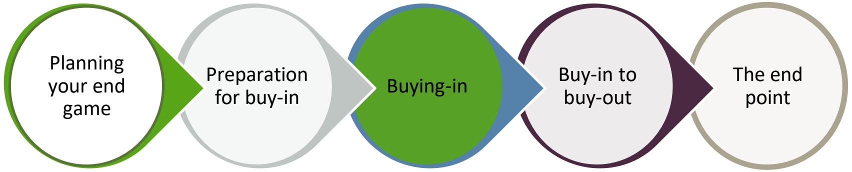


Managing the insurer experience . . .

- Important to understand that process will go much better if the scheme "manages" the insurer experience
- Insurer – especially if residual risk cover is on the table – will make extensive enquiries – visits etc to the administrator – sampling etc
- Schemes need to be "on the front foot" ie review processes and documentation and have the story straight . . .
- Insurers can be spooked by poor administration and legal uncertainty

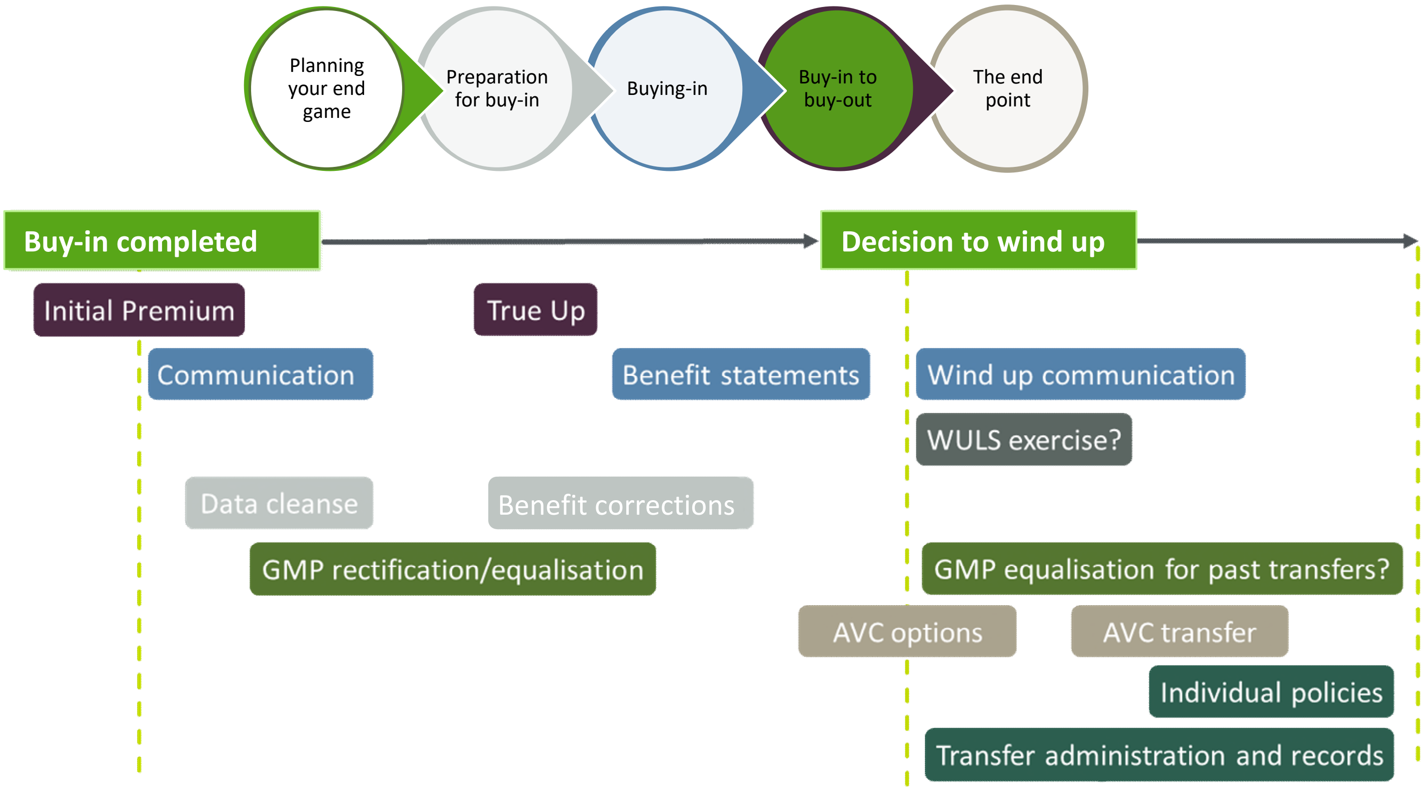


Key issues in the journey

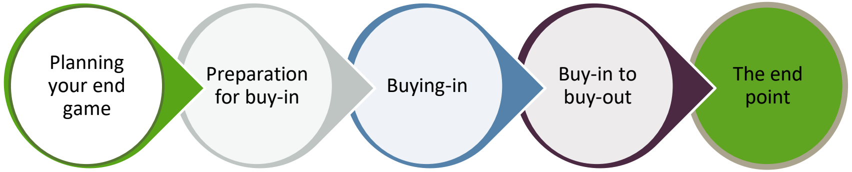


- Negotiating the contract . . .
- Often told that insurers have standard terms – they do but they can often be amended ☺
- Key points to consider:
  - Securing the right benefits for members:
    - Scope and timing of data verification
    - Flexibility to add members or adjust benefits
    - Insurer rights to change pricing basis, charge additional premia, or “cut off” liability
  - Statutory discharges
  - Scope of warranties and any indemnities given by trustee
  - Reliance on the employer indemnity

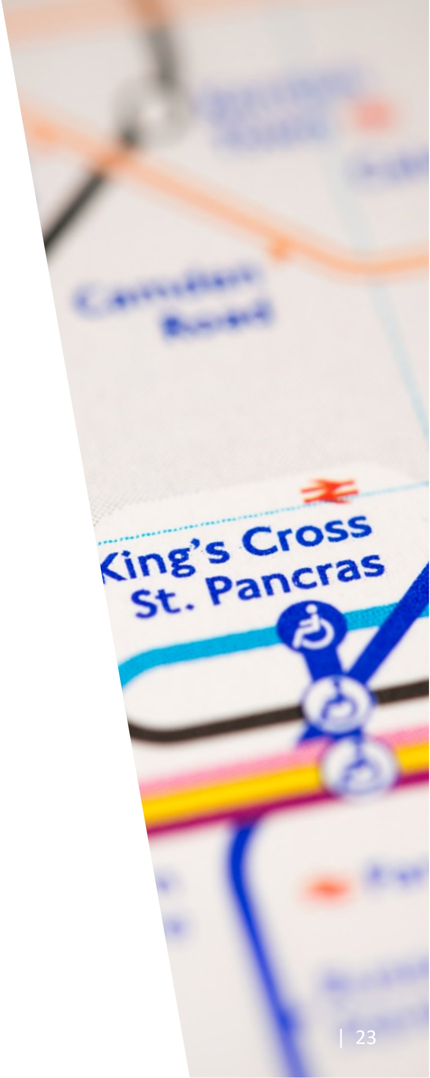
Moving from buy in to buy out/wind up- Timeline



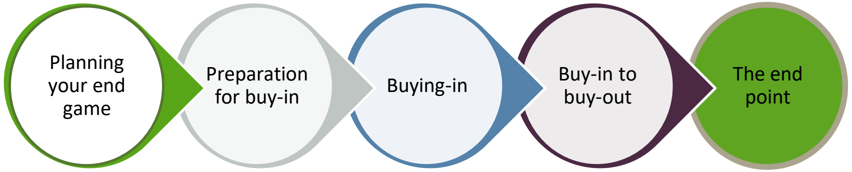
Protection for members in buy-out: the insurer

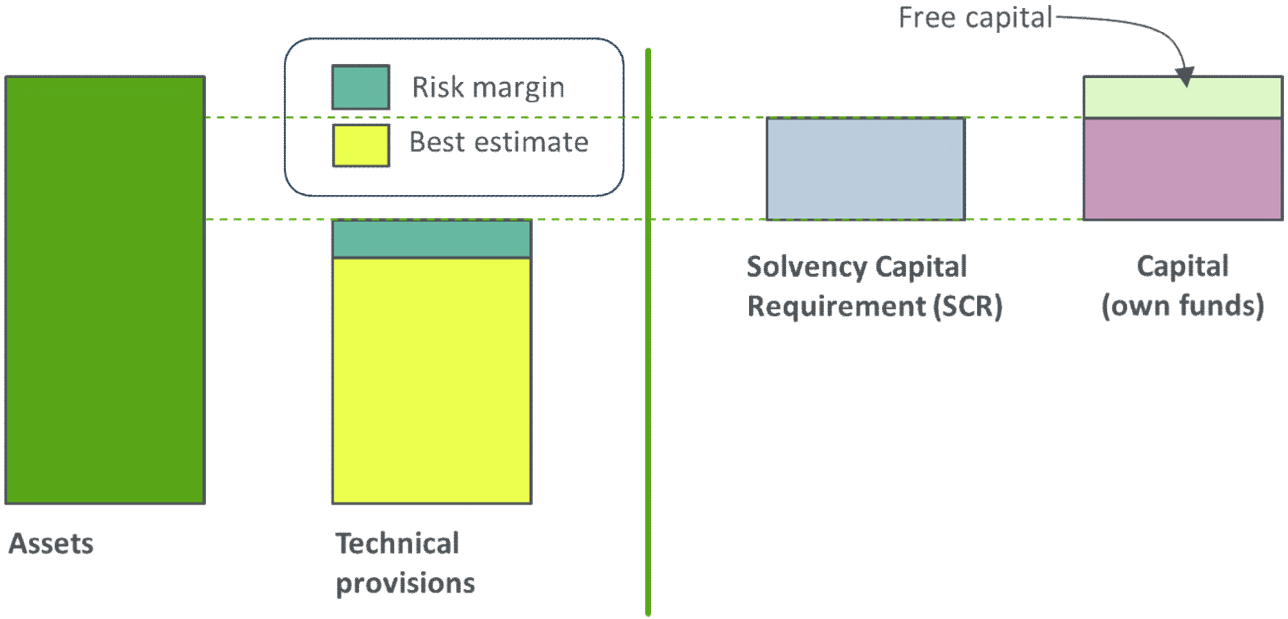


- PRA and FCA
- Strong prudential regime
  - Solvency II balance sheet
  - Solvency Capital Requirement (SCR)
    - Principle: probability of the insurer becoming insolvent in any year is limited to 0.5% (1 in 200 year event)
    - Calculated using standard formula or a full or partial internal model
  - Risk appetite (capital policy) – typically 20-50%+ above SCR
- Extensive conduct regulation

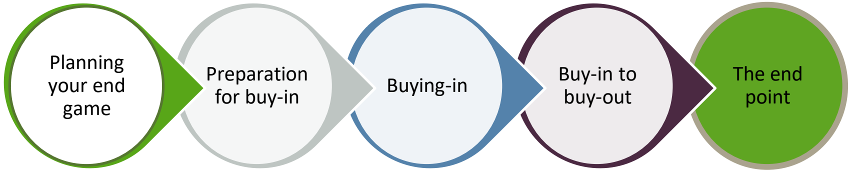


Solvency II balance sheet



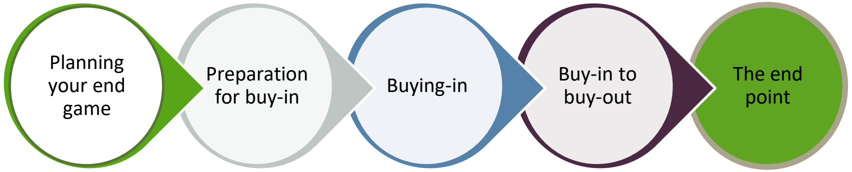


Hot topics to note

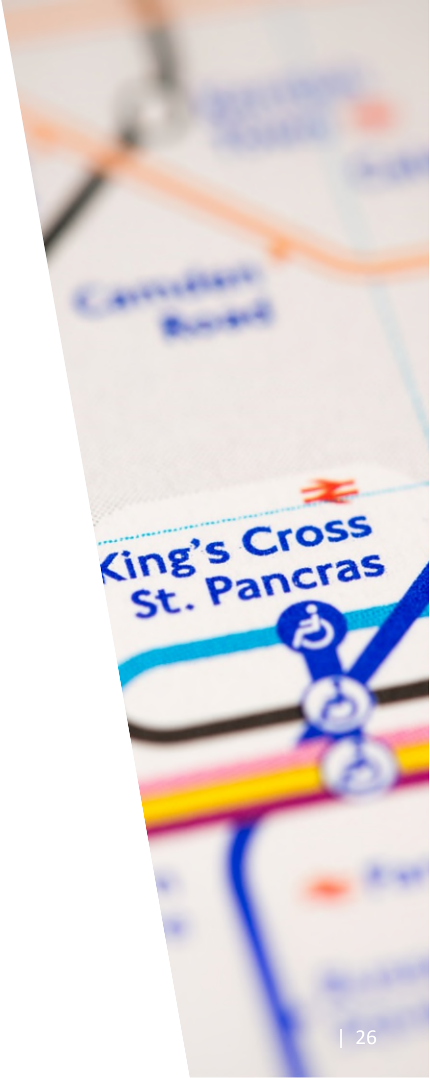


- Reform to Solvency II
  - Current status
  - Risk margin
  - Matching Adjustment
- Use of funded reinsurance
- New Consumer Duty

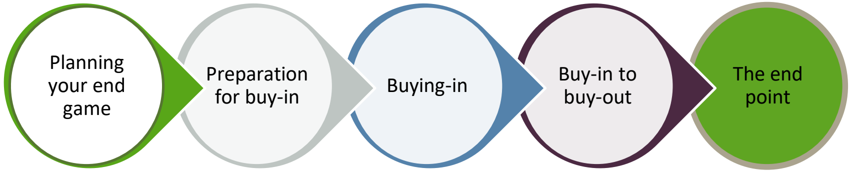
Protection for members in buy-out: FSCS



- Scope of the regime
- Potential problem areas



Making sure trustees are protected throughout the journey



- In a perfect world – all benefits secured for the right amount to the right people
- In practice, despite best efforts there may be some liabilities remaining
- Once a scheme has bought out and wound up – no assets sitting in a pension scheme to meet a claim
- Number of possible protections for trustees . . .
- Practical point – spend time cleansing data as thoroughly as possible before buy-out!
- Agree desired protections pre buy-in with employer in Framework Agreement/MOU?

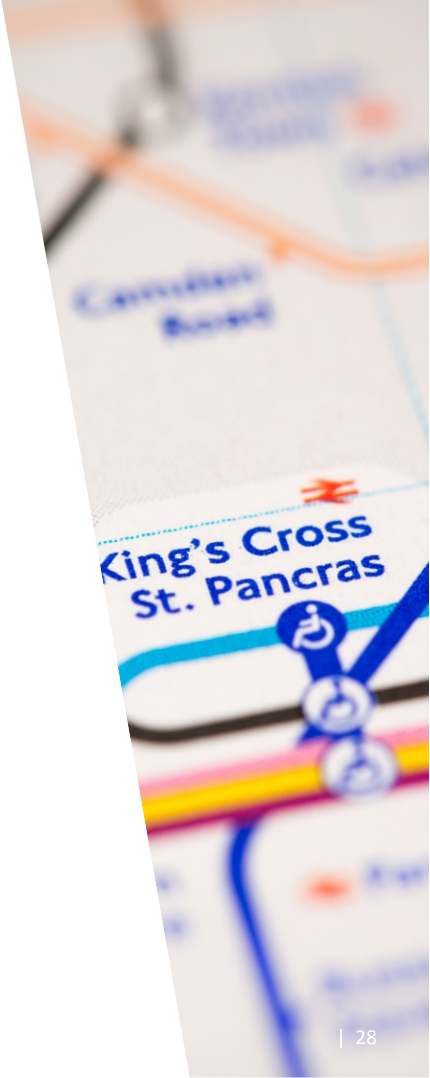
Risks for the Trustee to consider

Planning your end game → Preparation for buy-in → Buying-in → Buy-in to buy-out → The end point

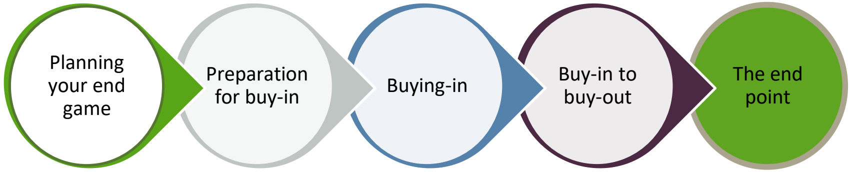
Incorrect benefits insured

Missing beneficiary comes forward

Claim against trustee

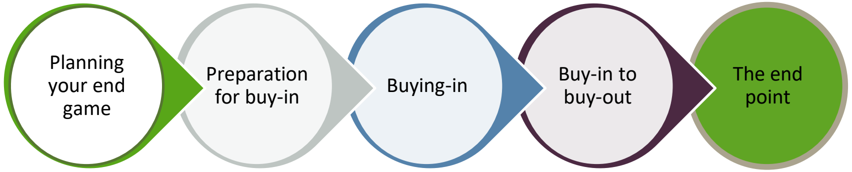


Statutory discharge and s27 notices

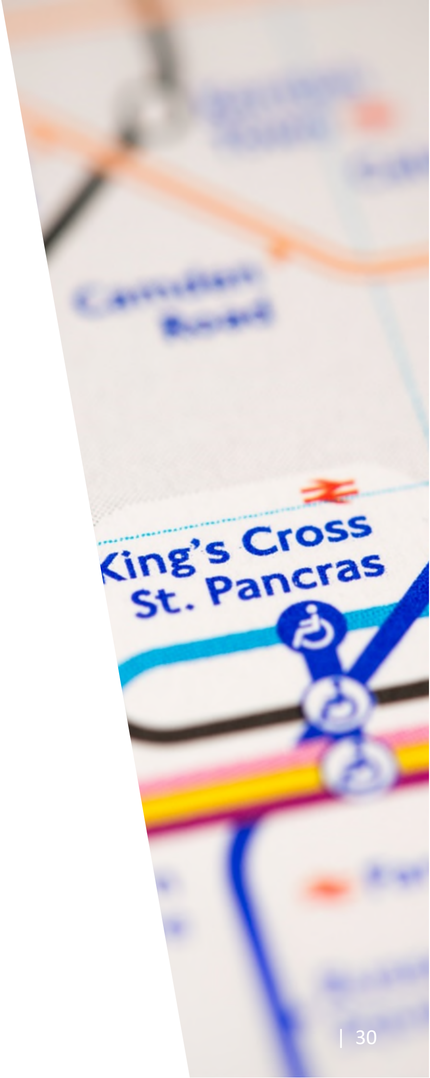


- Statutory discharge under s74 Pensions Act 1995/related regulations:
  - Trustees can discharge liabilities by purchasing insurance policies
  - Policies must meet certain conditions – check they are met!
  - Discharge notices to members
- Notices under section 27 Trustee Act 1925
  - Notice of intention to wind up to potential claimants (min 2 months)
  - Advertise in the well-read London Gazette (!) (any other papers?)
  - Protects against true unknown members
  - BUT not members the trustees have “forgotten”?!

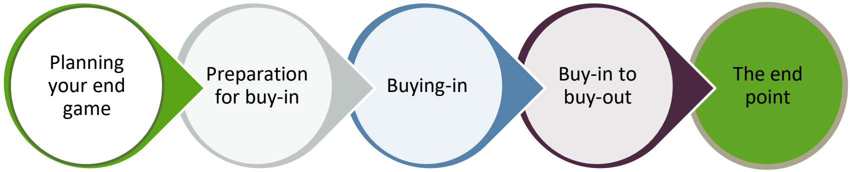
Claims against the trustee



- Who would a claim be against?
  - Corporate trustee – corporate veil should protect
  - Consider winding up trustee company after wind-up of scheme
- Limitation periods
  - Limitation periods may apply to some claims
  - Depends on nature of liability
  - No limitation for some claims?

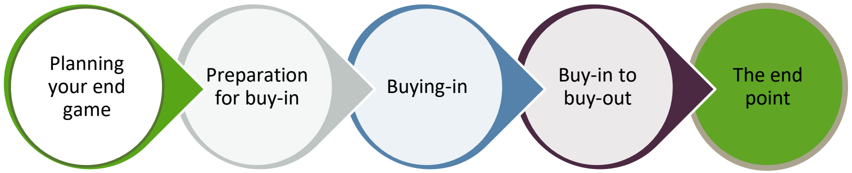


Trustee insurance

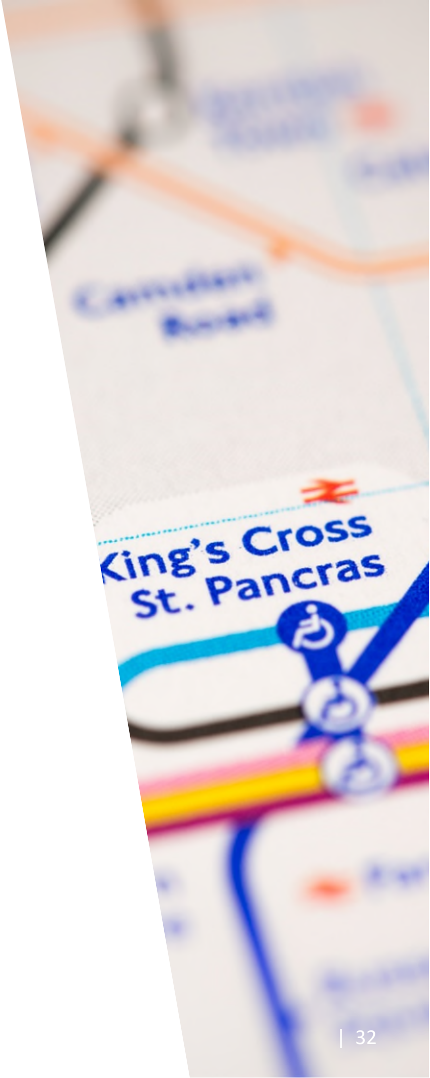


- Different types of insurance available – can be layered
- Overlooked beneficiary insurance or residual risk with buy-out insurer?
- Trustee run off insurance . . .
- But insurance has its limitations:
    - Coverage
    - Duration
    - Monetary limit
    - Professional trustees?

Employer indemnity and deed of termination



- Employer indemnity:
  - Understand position under rules
  - Employer indemnity after wind-up
  - Terms/duration?
- Deed of termination
  - Document agreed employer indemnity
  - Releases trustees from any further liability under scheme



Any questions

Claire Southern
Partner, London
Pensions

Duncan Buchanan
Partner, London
Pensions

Jonathan Russell
Partner, London
Corporate Insurance

Charlotte Yeates
Senior Associate, London
Pensions

www.hoganlovells.com