Original Article

Pensions buy-out: Deal or no deal?

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ABSTRACT This paper considers the buy-out process from the perspective of trustees of UK occupational pension schemes. It considers the decisions faced by trustees and the legal factors that trustees need to consider before and during the buy-out process. Proceeding with a buy-out policy to secure all or part of the pension benefits is often a one-off decision for trustees so they must get it right. Practical tips are offered to assist with the smooth running of a buy-out transaction, which is often complex. The key lies in (1) good preparation and project management and (2) a good network of advisers to provide support and advice along the way. The global financial downturn and its impact on the UK pensions buy-out market cannot be ignored. The financial downturn has, to some degree, put the pensions buy-out market on hold in the United Kingdom. However, once the markets stabilise, we expect insurance-based pensions solutions in the United Kingdom to come back to the fore.

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WHAT IS A BUY-OUT OR BUY-IN?

The term buy-out usually refers to an insured buy-out, in which an occupational pension scheme transfers the responsibility for its pension obligations from the scheme to a regulated insurance company. A full or partial buy-out of benefits leads to individual insurance policies being purchased for members.

An alternative is to purchase a buy-in policy. This is where the scheme purchases an insurance

policy covering the benefits of members.

This policy becomes an asset of the scheme that matches the liabilities in respect of insured members. The pension scheme receives a regular payment from the insurer that exactly matches the sum of the payments the scheme owes to its members.

There have been other transactions in the United Kingdom, which involve a non-insured solution to securing all or part of the pension liabilities. Typically, non-insured solutions involve corporate deals in which all or part of the pension liabilities are transferred from one corporate sponsor to another. Such transactions are often complex and are not strictly 'pension buy-outs'. Non-insured solutions are not

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considered in this paper but trustees should be aware that there is a further alternative available.

FULL OR PARTIAL BUY-OUTS

Pension buy-outs with an insurance company can be either full or partial buy-outs.

A full buy-out involves the transfer of all of the pension liabilities to the insurance company. Once the individual insurance policies have been issued to the members then the wind up of the scheme can be completed and the trustee's responsibilities discharged.

A partial buy-out is different from a full buy-out because not all of the liabilities in the scheme are insured. This means that the scheme will remain in operation and will continue to manage the uninsured liabilities. When proceeding with a partial buy-out it is important that trustees carefully balance the interest of one group of members against another group of members. This is particularly important if the scheme is under-funded and, for example, pensioner benefits are secured with an insurance policy whereas the deferred member benefits are not. There is a risk that securing one group of members benefits will weaken the position of the non-insured members.

TREND IN THE UK BUY-OUT MARKET

The UK buy-out market accelerated during 2007 and the early part of 2008. The following Table 1¹ sets out the top 10 buy-out deals for UK listed companies during this period of growth.

There was a lull in UK buy-out activity in the last quarter of 2008. This was fuelled by the global financial crisis, which led to a sharp reduction in liquidity. Expectations that the buy-out market in the UK would hit £10 million in 2008 following the rapid growth in 2007 have proved optimistic with total business placed for the year of £8 million.²

However, amid this slump in the market, Pensions Insurance Corporation completed the largest ever UK pension buy-out by agreeing to take on the Thorn pension scheme's liabilities of £1.1 billion.³

Table 1: Top 10 buy-out deals for UK listed companies during 2007–2008

<i>Company</i>	<i>Transaction date</i>	<i>Liabilities bought out or bought in</i>
Emap	13 November 2007	£170 million
Weir Group	17 December 2007	£240 million
Rank	29 February 2008	£700 million
Morgan Crucible	17 March 2008	£160 million
BBA Aviation	22 March 2008	£270 million
Smiths Group (own TI Group)	21 April 2008	£250 million
Friends Provident	15 May 2008	£350 million
Raven Mount (own Swan Hill)	28 May 2008	£72 million
Delta	5 June 2008	£451 million
Cable & Wireless	3 September 2008	£1 billion

Once the global markets stabilise, insurance-based solutions in the United Kingdom are expected to come back to the fore. There are indicators that the market will pick up in 2009. Some commentators suggest that trustees and their advisers may have been deferring their decision to transfer all or a portion of a pension scheme off the balance sheet until markets are more settled. Therefore, some transactions that may have taken place by the end of 2008 may now have taken place in 2009.⁴

Hymans Robertson asked trustee delegates at a seminar if they expected their pension scheme would buy-out some – or – all of its benefits with an insurance company. Some 9 per cent had already done so; 31 per cent expected it to be within the next decade; and 23 per cent said within the coming 3 years. The remaining 37 per cent opted for not within the next 10 years or never.⁵ This suggests that there is still an appetite for buy-out solutions over the coming years. So long as trustees and sponsoring companies are looking to remove liabilities then an insurance-based solution is likely to remain on the table.

THE IMPORTANCE OF THE TRUSTEES

Trustees have a pivotal role both before and during the buy-out process. The trustees must decide whether a buy-out or buy-in is appropriate for the scheme. They need to then decide on the insurance provider to proceed

with following a process of due diligence and go through the various legal steps to complete the buy-out.

The chairman must guide the trustees through the buy-out process: from the decision to proceed as well as the various legal and actuarial hoops along the way. Trustees need to have a strong team of legal and actuarial advisers to guide them through what is often a complex process.

TRUSTEE DECISIONS

Decision to proceed with a buy-out or buy-in

When considering an insured solution, trustees have four options:

1. Do nothing;
2. Partial buy-in;
3. Partial buy-out; and
4. Full buy-out.

Trustees must recognise that to ‘do nothing’ and continue the status quo is still a decision. Should the trustees ever be challenged in the future that they missed an opportunity to secure members benefits in full, they must be in a position to justify this decision. This emphasises the importance of recording all trustee decisions together with the reasons accurately.

In making this decision, trustees should consider the legal factors set out in the section ‘Legal factors trustees must consider when proceeding with a buy-out.’ It also means considering any such factors that are relevant to the scheme specifically and any other factors highlighted by the scheme’s other advisers.

Trustees need to make sure that all the decisions are fully documented and a paper trail is in place in the event that the trustee decisions are ever queried in the future.

Deciding which insurance provider to proceed with

Having decided to go for an insured option, trustees then have the additional decision to make about which insurer to select. Every scheme is unique and most insurance providers will be

prepared to tailor their offer to the needs of the scheme. It is important that the trustees work alongside their advisers and the insurance provider in developing the insurance solution. Below is a checklist of issues trustees need to be addressing when choosing an insurance provider:

Price

- What is the premium being charged?
- How will the price move with market movements?
- What is included? Is it an ‘all risks’ policy? Does it cover guaranteed minimum pension equalisation risk?
- Is the price affected by the nature of the assets transferred?
- Is the price affected when the administration switches across to the insurer (to the extent that this is relevant)?

Experience in the market

- Is the insurer an ‘established player’ with a long and positive track record?
- If not, does the board/staff of the insurer have a long and positive track record?

Member perception/brand

- Will members know the insurer?
- Will members feel ‘safe’ with the brand of the insurer?

Administration

- How strong is the insurer’s administration service? Is it internal or sub-contracted?
- What governance mechanism is in place for any sub-contracted administration services?
- Are there any offshore administration services?

Financing/risk

- Will the insurer have access to further capital if needed?
- What proportion of liabilities will the secured liabilities represent?

- What is the insurer's approach to longevity and risk hedging?
- What assumptions has the insurer used in their model for discount rate, inflation and life expectancy? What is the scheme actuary's view of these?
- How strong is the internal risk governance structure of the insurer?
- Does the insurer have confirmation from the Financial Services Compensation Scheme (FSCS) that it would be available in the event of the insurer's failure?
- Is the insurer prepared to offer additional security in some form?

In order for the trustees to get an understanding of the buy-out market and what it is on offer it is important that the trustees investigate more than one insurance provider. While there is no steadfast rule on how many insurance providers trustees should consider, it is important that the trustees feel they have made the necessary enquiries to secure what they consider to be the best deal for all the members of the scheme.

LEGAL FACTORS TRUSTEES MUST CONSIDER WHEN PROCEEDING WITH A BUY-OUT

There is a wide range of factors trustees must consider during the buy-out process. This is why the advisers are critical in guiding the trustees through the process. Below is a list of legal factors trustees should take into account. Trustees must also consult with their actuarial, investment, covenant and any other appropriate advisers before proceeding.

The decision involves the trustees exercising a discretion as well as often being an investment decision.

Exercise of trustee discretion

The decision to proceed with a buy-out or a buy-in is a discretionary decision, which means that trustees must give

proper consideration to the matters which are relevant and exclude from consideration matters which are irrelevant.⁶

In practice, this will involve a consideration of

- the scheme rules;
- the interests of each class of beneficiary;
- any alternative solutions;
- covenant review of the insurance provider and the sponsoring employer;
- the FSCS and the Pension Protection Fund (PPF); and
- discharge of liability.

These have been considered further below. This is not meant to be an exhaustive list but an example of the types of issues trustees will need to consider.

Scheme rules

As always, it is important that the trustees check that they have power to effect the transaction. Usually, this will be relatively straightforward for a buy-in or a full buy-out. It may be more complex for a partial buy-out. If no suitable rule exists, an amendment will need to be considered in the context of the specific amendment power under the scheme.

Consideration of all classes of members

Trustees have a fiduciary duty to consider properly the interests of all members of the scheme. This means all categories of members: active, deferred and pensioner members. Trustees must be mindful of the impact of any decision on each category of member and be comfortable that the result is a fair one. The trustees must be satisfied that entering into the transaction is consistent with the purpose of the scheme and the interests of the scheme's beneficiaries as a whole.

Situations that may arise in practice include

- A partial buy-out situation will involve a split of the scheme's assets between those to be transferred to the insurance provider by way of a premium to secure the benefits and those assets to remain in the scheme. Is the split fair between those members being bought out and the residual assets that will remain in the scheme?

- Does the transaction materially weaken the covenant of the sponsor available to the residual fund if the sponsor is providing a 'top up' to the premium?
- Are there any discretionary benefits under the scheme? If so, the insurance provider is unlikely to be able to exercise such a discretion once the benefits have been secured or when an individual policy is issued. Trustees need to consider whether the members' benefits will be adversely affected.

Alternative solutions

Are there any alternatives to the proposed insurance solution? It is not necessarily clear how far trustees need to go in considering any alternatives. Such an exercise could be never ending and result in missing an opportunity in the market and could itself be open to challenge.

A pragmatic approach needs to be taken. This may include considering a range of insurers for an insured solution and any non-insured solution on the table (either by the sponsoring employer or from the advisers). Any other alternatives may include other liability management exercises such as enhanced transfer values. What is on the table at any one time will be scheme specific. The scheme's advisers can guide the trustees as to the appropriate amount of consideration that needs to be given to all of the alternatives. Of course it may be that the additional funds needed to complete a transaction will only be provided by the sponsor in one of the possible options.

Covenant review

Trustees will need to carry out a covenant review. This will involve a financial analysis of the insurance provider. There are specialist advisers who are able to carry out such reviews to a varying degree of cost and depth.

The last few years have seen a growth in UK trustees obtaining more detailed covenant reports. This seems to be prudent in an unsettling financial market in which even known brands previously considered to be 'safe' have been under severe pressure.

In a full buy-out, a covenant review will involve a review of the strength of the insurance provider's covenant to ensure that it is at least equal or ideally better than the current covenant.

In a partial buy-out, there is an additional dimension to the covenant review. Not only will the covenant of the insurance provider need to be considered to ensure that it is at least as good as the current sponsoring covenant but also the covenant of the sponsoring employer will need to be reviewed too to ensure it is not materially weakened by the transaction such that the security of the residual, non-insured members could be adversely affected. This may occur, for example, if the pensioner member benefits are secured with the insurance provider and the deferred and active members remain in the scheme. Each case will be very specific to its own facts.

It is important to remember that any covenant review involves a certain amount of crystal ball gazing and it is not possible to say for certain whether any given insurance provider will survive. This is particularly evident given the unprecedented events in the financial market in the past year. This being said, it is important that the trustees are armed with the information best available to them at the given time when deciding whether or not to proceed.

Financial Services Compensation Scheme versus the Pension Protection Fund

Sitting alongside the covenant review is the consideration of the PPF as compared to the FSCS.

The PPF provides compensation to members of final salary schemes in the event that the sponsoring employer goes insolvent. The FSCS provides compensation to policyholders in the event that a Financial Services Authority regulated insurance company goes insolvent.

The PPF provides two different levels of compensation. For those who have reached the pension scheme's normal pension age at the date of the insolvency event or, irrespective of age, are already in receipt of a survivor's pension or a pension on the grounds of ill health, the

PPF will pay an amount equal to 100 per cent of those people's benefits as (excluding certain pension increases) compensation.

For those people below their scheme's normal pension age, the PPF will only pay a 90 per cent level of compensation. This compensation is also subject to an overall cap, which, for the period from April 2008 to March 2009 equates to £30 856.35 p.a. at the age of 65. The cap is adjusted according to the age at which compensation comes into payment.

Under the FSCS, in the event that the insurance company becomes insolvent and the pension scheme member holds his or her annuity policy with the insurer, the member will receive 100 per cent of the first £2000 of their 'claim' and 90 per cent of the remainder of their claim.⁷ This should include all pension increases. There is no limit on the overall level of compensation. There are some uncertainties as to what a 'claim' means exactly and under what circumstances the FSCS will provide coverage. For example, in a buy-in situation will the 100 per cent of the first £2000 apply to per member on the policy or just to one policy? Also, after a partial buy-in of members' benefits in which there remains a liability within the pension scheme, which has not been discharged or in a non-wind up buy-out situation (where there is no statutory discharge of certain contracted out benefits), will the FSCS be willing to provide coverage even though someone else (that is, the sponsoring employer) still retains the liability technically?

Although a number of these ambiguities remain, Punter Southall has reported that following its investigations, the FSCS has confirmed its responsibility for providing protection to pension schemes that have been sold to insurance companies.⁸ This includes confirmation that beneficiaries under a buy-in will get the same protection as would members following a buy-out. At the time of writing this is yet to be confirmed by the FSCS.

The trustee comparison of the compensation levels offered by the PPF and the FSCS needs to be kept in context: while trustees must consider all eventualities, it is one factor among a whole host of other factors that trustees will be

considering as part of the transaction. The relative likelihood of insolvency of the insurer and the sponsor is of course also important.

Discharge of liability

An issue for the trustees to consider on a buy-out is whether they will receive a statutory discharge of liabilities as a result of the transaction. This is important to trustees (either as individual trustees or as director trustees of a corporate trustee) and the sponsor because without the appropriate discharge there is a risk that liability remains in the scheme. Trustees must remember (despite the importance of the issue to them personally) this is a secondary issue in their capacity of trustees to the scheme: any statutory discharge concerns must not override the consideration of whether the transaction is for the benefit of the scheme overall. However, in most buy-out situations, obtaining a statutory discharge will be a key element of the overall transaction for the parties.

Investment decision to enter into an insurance policy

As well as an exercise of a trustee discretion, the decision whether to buy-in (that is, purchase an insurance policy as an asset of the scheme) is essentially an investment decision.

In relation to any investment decision, the courts have stated that trustees must act prudently and

take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide.⁹

The decision will involve consideration of the scheme rules and the investment legislation.

Rules of the scheme: Do the trustees have the power to enter into the transaction?

Trustees need to review (and receive legal advice) in respect of the rules of the scheme. Do the rules allow the trustees to enter into a bulk buy-in policy? This is likely to be set out in the investment provisions.

If the rules do not provide the trustees with this power it may be that the rules can be

amended. Again, the trustees will need to obtain legal advice before making any amendments to the scheme rules.

The rules need to be considered to see if there are any other restrictions or considerations for the trustees entering into a transaction of this type. In addition, it is a statutory requirement for the trustees to consult with the employer before adopting a particular investment approach. Although this should not cause any problems to the extent that all parties are working together, it is important that all such requirements are met so to reduce the risk of challenge to the process at a later date.

Investment legislation

Trustees need to comply with the investment legislation. In England and Wales this comprises the Pensions Act 1995 and the supporting Investment Regulations.¹⁰

Under the Pensions Act 1995¹¹ trustees are required to obtain written investment advice that investments are satisfactory, having regard to certain criteria and diversification requirements laid down by the Investment Regulations. The trustees need to ensure that they receive written investment advice confirming that entering into the insurance policy will meet these requirements. This may result in the Statement of Investment Principles needing to be updated.¹² As noted above, consultation with the employer is also required.

PRACTICAL TIPS FOR TRUSTEES

The buy-out or buy-in process can be long and complex. The key practical tips for trustees to help the transaction run smoothly are

- good preparation;
- good project management; and
- good network of advisers to provide advice and support throughout the whole process.

Good preparation

Good preparation is crucial. This includes tidying up the member data, any guaranteed minimum pension issues and all administrative records.

Buy-in and buy-out transactions will involve a process of data cleansing so that the final price of the premium can be established. Clean data from the outset reduces the risk of any unforeseen difficulties arising during the data cleansing process. This in turn reduces the trustees' exposure to a hefty adjustment in the premium price.

Good project management

Good project management needs to be established from the outset. Although investing in good project management in the early stages of a transaction may seem an unwelcome expense, it is likely to save costs that may be involved in resolving issues which have been overlooked.

Good project management includes agreeing a project plan between all of the parties, which sets out the tasks and realistic deadlines for the tasks to be completed. This needs to be regularly updated and monitored as and when further issues come to light (which they inevitably will). All parties need to be working in accordance with the agreed project plan. This helps to focus all the parties and advisers and prevents people running with their own work stream without considering the objective of the wider transaction.

All of the trustee decisions need to be carefully recorded in the minutes. As demonstrated above, there is a wide range of issues to be considered by the trustees and these need to be reflected in the minutes. Not just the final decision itself but also how the trustees reached this decision (and reference to any accompanying advice from the scheme's advisers). Should any of the trustee's decisions be challenged in the future, the trustees need to be able to point to when a decision was made and, crucially, why it was made. A list of all the factors to be considered will help the trustees to reduce the risk of anything being missed.

The trustees need to have an accurate and complete record of the documents accompanying the transaction. This will include a copy of the insurance policy, all advice from the advisers (trustees need to ensure that they receive written advice from their advisers for these purposes), member communications and any other documents that are central to the transaction.

An individual or organisation needs to be nominated to be in charge of the project management. Depending on the size and complexity of the transaction it may be a worthy investment for the trustees to appoint a project manager. This will free up the trustees and advisers to consider the decision-making process and carry out the transaction rather than getting caught up in the day-to-day running of the project.

Good network of advisers

The theme throughout this paper is the importance of good advisers to provide the trustees with support and guidance throughout the whole process. Spending money on the advisers to see if the transaction can be done initially will be better than launching into the process after thousands of pounds has been spent only to discover that there are problems, which mean that the transaction cannot proceed.

It is also helpful if the advisers can be involved throughout the whole process rather than dipping in and out when required. This helps to ensure all the advisers are up to speed to provide quality advice and guidance to the trustees. It also saves time and money later getting the advisers up to speed when they are needed. Experience shows that the smoother transactions involve those advisers who work closely together to spot and resolve issues together.

The buy-out process will require time and commitment from the trustees, which is often underestimated by trustees. It is important that trustees are aware of this from the outset to ensure that they can make arrangements so that they have the time and availability to embark on the project.

In order to reach the optimum outcome, trustees need to have clearly understood objectives from the buy-out exercise and the issues involved. A working relationship with the scheme sponsor, insurance provider and all advisers will help this process to understand what each party is trying to achieve and to ensure that all parties are working together to achieve it.

CONCLUSION

The buy-out market in the United Kingdom has grown over the past couple of years and, despite the downturn during the last part of 2008, is set to continue. With the prospect of an insured solution being increasingly likely to be on the trustees' and sponsor's agenda, it is crucial that trustees recognise their pivotal role in such a transaction.

There are many factors that trustees need to take into consideration before proceeding with a buy-out or buy-in. Some of these have been discussed, but many will arise due to the circumstances of a particular scheme. At all times, trustees need to be satisfied that the transaction will be in the interest of the beneficiaries as a whole.

A buy-out or buy-in transaction is often complex. The key to a smooth-running transaction is good preparation, good project management and a good network of advisers. The advisers need to be on hand to guide the trustees through the decision-making process.

Trustees need to make sure that all the decisions are fully documented and a paper trail is in place in the event that the trustee decisions are ever queried in the future.

DISCLAIMER

This press article may contain information of general interest about current legal issues, but does not give legal advice.

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