Pensions: **Corporate Agenda**

SUMMER | 2019

Buy-ins, Buy-outs

A buy-in or buy-out will exactly match the liabilities it is agreed the policy will cover. Because of this, it is often seen as the ultimate form of liability matching.

In a nutshell

A "buy-in" or "buy-out" is simply an insurance policy taken out by the pension fund. For both, a premium is paid to an insurer.

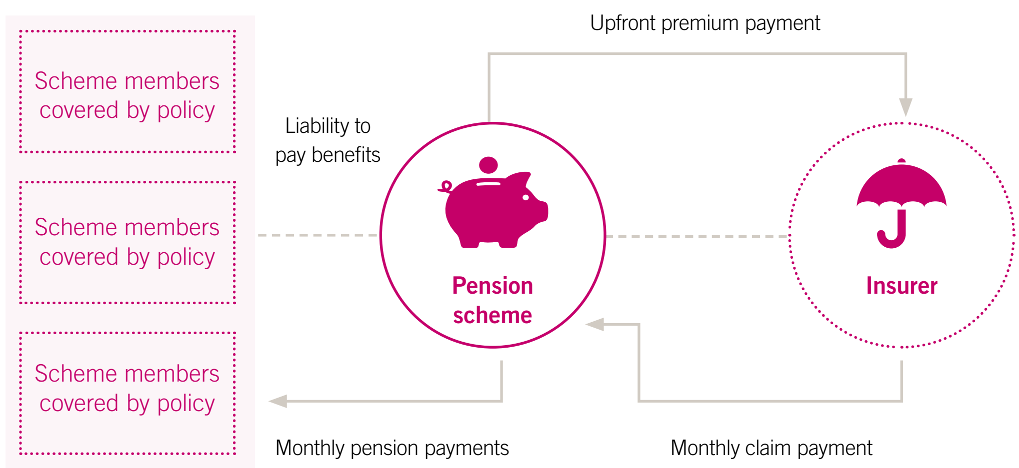
For a buy-in, the insurer will make scheduled payments (usually monthly) under that policy to match the pension fund's ongoing liabilities. The insurance policy is in the trustee's name and an asset of the scheme. The trustee and its administrator continue to operate the scheme as usual, but instead of payments of benefits being made from scheme assets, they are funded by payments under an insurance policy.

A "buy-out" is an insurance policy where the insurer steps into the shoes of the trustee, and issues individual policies to scheme members. The members' benefits are provided directly by the insurer. The trustee and the employer are extinguished from liability in respect of those benefits bought out. If all benefits are bought out, the scheme usually winds up.

Buy-ins and buy-outs may be referred to as a bulk annuity policy.

Buy-in will often precede buy-out, as the process of buy-in is often a temporary period for schemes to get their house in order before moving to buy-out. Buy-in and buy-out policies can cover the whole scheme or only a select group/category of members.

An illustration of a buy-in is set out below.



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How do you do it?

The initial stages leading up to a buy-in or buy-out can take a long period of time.

The scheme will usually go out to insurers for a quote on the basis of the benefit summary and any key terms required for the contract. The scheme will then award exclusivity to an insurer or insurers meaning the scheme will not deal with any other insurer for a set period and in return the insurer may give some certainty over the pricing terms if an insurance policy with the insurer is entered into by the end of the exclusivity period. During this exclusivity period, the insurer will perform further due diligence on the scheme's data and records.

Once the terms are agreed, the policy can be signed, and the buy-in period starts. If the policy is a buy-out, there is usually a short buy-in period so that everything is in order before the insurer issues individual policies.

In the buy-in period, the insurer and administrator will normally manage the process of reporting the benefits payable, so the insurer can calculate the amounts due. There is usually a verification or reconciliation of membership data required, often called a "data cleanse", after the start of the buy-in and this can take time to complete. Things that are often checked are members' dates of birth, marital status and address.

What do schemes need to think about when planning a buy-in or buy-out?

Benefit specification

A benefit specification sets out the benefits which are payable under the policy to members. The intention is usually to reflect the scheme's benefits. As members' benefits are governed by the rules in force when they left pensionable service or retired, the scheme and its advisers will need to review historic rules to accurately document what benefits are payable for all members. Some things to note are that:

- the benefit specification needs to specify the benefits and discretions for all historic members and take account of any enhancements, transfers in and administrative practices;
- anything not mentioned in the benefit specification or in the contract is not insured;
- sometimes issues come out of the woodwork once the benefit specification is being prepared, and decisions need to be made on what the insurer will be asked to insure; and
- there is sometimes a difference between what the rules prescribe and what the insurer can provide, and this needs to be managed in advance.

Key areas of negotiation

There are some key areas where we see most negotiation when agreeing the insurance policy.

What is insured and what isn't?

- The scheme and its administrator will need to be sure they know which benefits are being insured, and which members are in scope to receive those benefits.
- Are any benefits excluded? The scheme will need to be clear as to which benefits are not being insured or any areas where there is a mis-match between what is provided under the policy and the scheme rules, whether due to administrative ease or otherwise. The scheme will remain responsible for any benefits not effectively discharged by the policy.
- Benefits may not always be replicated exactly as required under the scheme's rules, and so benefits may be simplified, providing a more generous position, or there may be a mis-match between what is provided under the policy and the scheme rules.
- For buy-outs, schemes will usually want the best match possible between the policy and the scheme's benefits.
- If the plan is to wind up and buy out the entire scheme, the scheme may need to consider how to deal with any risks not dealt with by the buy-out. Options here include run-off insurance or indemnities from the employer.

What options can the insurer provide?

- Discussions should be had up front about anything unusual, so the insurer can check whether they can facilitate what you want.

Will the scheme need to make an additional payment?

- If there is a change to benefits or the member data due to the data cleanse, a further premium may be due as these changes may impact on the insurer's pricing. Care will be needed to make clear what benefit changes are included in the price, and which are not. If a member's benefits are discovered to be incorrect and they need to be increased or reduced, how will the insurer do this, and will there be an additional premium?

What happens if the law changes?

- What happens if the law changes (e.g. like on GMP equalisation)? Who will bear responsibility for this?

What warranties do you have to give?

- The trustees will usually warrant the accuracy and completeness of the data provided to the insurer, and that it has been taken from the administrators' system without amendment.
- It is important that the trustee can give the warranties based on the due diligence completed. The scheme will need to work closely with its consultants, advisers and administrators to feel comfortable giving warranties on the basis of the information given to the insurer.

Ability to issue individual policies

- A buy-out occurs when the insurer issues individual policies to the members.
- The scheme will want to ensure the preparatory work is completed in advance so the buy-out is not held up.
- The scheme will also want to ensure that any individual policies issued provide the trustee with the statutory discharge it needs.

Can the scheme terminate the policy?

- Buy-in and buy-out contracts will often have limited termination rights, if any.
- Usually, if the policy terminates, a percentage of the premium is returned to the scheme, with the insurer's margin deducted. Termination triggers could include the trustee’s fraudulent and material breach of warranty, or the insurer losing their business licence.

Collateral

- Collateral is used to mitigate the risk of an insurance company failure which would mean it could not meet the future payments due under the buy-in. Some larger buy-ins have been collateralised, but there is no market norm here.
- The scheme will need to consider whether it wants collateral for its buy-in and to recognise the advantages and disadvantages of this.
- The UK insurance regulatory regime is highly regulated, so schemes may not feel this is needed. Collateral adds complexity and cost to any process.

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