

Supporting pension de-risking transactions: the custodian's perspective

Defined benefit (DB) corporate schemes in the UK continue to “de-risk” their funding deficits using insurance-based strategies. The use of tools such as bulk annuities and longevity insurance has exploded recently; the value of pension buy-ins and buy-outs alone has exceeded £25 billion¹ in the past two years.

Less well-known is the role of the custodian and asset servicer in supporting insurance-based de-risking. Mark Austin, Head of Insurance for Europe, Middle East and Africa at Northern Trust, explains that its expertise in areas that are significant in executing these transactions – asset reporting, safekeeping, valuation, risk management and the movement of collateral – has seen it increasingly involved in providing support here. Deals have spanned the use of longevity insurance and bulk purchase annuities, particularly buy-ins, where the insurer assumes responsibility for meeting all or part of the scheme's pension commitments, but the scheme maintains its relationship with members.

“We have an overarching view of some of the key challenges and potential pain-points involved in concluding these types of deals,” he says, “and understand the key factors in achieving successful outcomes. From contractual arrangements to pricing and preparing assets for transfer, there is an awful lot a pension scheme must achieve in a short space of time when entering into these transactions. Early consideration of certain factors can help achieve the desired result.”

EARLY ENGAGEMENT

So what are some of the keys to a smooth transaction? “Starting as far in advance as possible is key,” says Austin. “These transactions are often price-sensitive, so the earlier that all parties can be brought together – ideally before the clock starts ticking – the better. If work can commence as early as possible on the custody and account control agreements, for example, there is less chance they will impinge upon the date on which your team wishes to make the transfer. Engaging early means you are more likely to be in a good position if you later need to react to favourable pricing – when speed often does become all-important.”

WHETHER TO COLLATERALISE?

The choice of whether to use a collateralised structure will affect the complexity and cost of the transaction. These are used to ring-fence pension scheme assets as a precaution against the risk of an

insurer failing, such that although the insurer can invest assets with autonomy, they are segregated and remain owned by the scheme. This means that, in the event of a distressed scenario (as yet untested), the scheme is able to recover those assets rather than take its chances as a creditor alongside others.

PREPARING ASSETS FOR TRANSFER

Preparing assets for transfer to the insurer's use can be complex and time-consuming: arranging in-specie transfers out of funds, for example, can be convoluted and sometimes require transition management services. Other potential situations could include instances where the scheme assets to be transferred are overexposed in ways that do not match the insurer's desired risk profile, so adjustments are made to more closely align them. “Also, when dealing with collateralised transactions, additional work may be required to move assets from the scheme through to the insurer and to the final accounts structure with a charge over them”, Austin says. “All of this takes time and planning.”

COLLATERAL MOVEMENT AND MONITORING

Once the groundwork is in place for a collateralised structure, collateral management is often required to move assets into and out of the insurer's control. Monitoring is also necessary to ensure asset movements comply with agreed valuation protocols and/or legal agreements. These may, for example, specify that assets moved must be of a particular quality, or that only those with certain exposures or distribution profiles should be involved.

Austin elaborates: “When considering asset movements, we sometimes see considerations around “eligible versus available” assets. This is the situation where the eligible assets that are easy to move in a collateral arrangement are often the best and most liquid ones, whereas a lot of the available assets – given where we are in the low-interest rate environment, with investors being ‘pushed out’ on the illiquidity curve – are less easy to transfer.”

It will also be necessary to maintain ongoing

valuations of assets for reporting, and all parties will need to consider aspects such as how frequently assets should be valued – on a daily, monthly, quarterly or other basis, for example.

PAYMENTS

How will payment be made to the insurer? Considerations here potentially include: what is the right structure for the arrangement – will there be a single one-off payment or multiple payments ongoing over several years? Is a single pension scheme involved, or several schemes that are to be funded concurrently? “The answers to those questions will likely play a role in deciding which type of structure you come to use, as will the assets involved and the relative size of transaction versus the cost-complexity involved,” says Austin.

LEGAL AGREEMENTS

Agreements will be put in place to underpin what has been decided. From the custodian's perspective, two of the most time-consuming items to work through are the account control and custody agreements, while items such as collateral and compliance agreements are generally more straightforward to put in place.

LOOKING TO THE FUTURE

With the UK's DB liabilities reported to be standing at over £2 trillion at the start of 2016 and only £150 billion of longevity risk hedged², the scale of the deficit issue remains acute and deal momentum has continued apace this year. Northern Trust and Mark Austin feel that the pension de-risking market will continue to be competitive as longevity risk continues to feature heavily among trustees' and sponsors' concerns. Finally, he re-emphasises the importance of preparing as far in advance as possible when entering into insurance-based de-risking transactions: “Bringing your teams together as early as possible to consider your options, potential partners, pitfalls and timings will continue to be key in reaching successful outcomes.”

FOOTNOTES

¹ Source: LCP De-risking Report, 2014 & 2015

² Source: Towers Watson De-risking report 2016