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THE CAPTIVE SOLUTION'S PLACE IN THE DE-RISKING TOOLBOX

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The last few years have seen a trend towards managing and, in several cases, transferring scheme risk. 2018 was the biggest year yet for bulk annuity activity with UK pensions funds transacting some £20 billion of buy-in and buy-out deals. At the same time, behind the scenes, there has been an increase in the use of captives to house defined benefit pension scheme risk.

In an article for Captive Review, Robus Chief Executive Richard Le Tocq looks at where captives sit amongst the alternative structures available and, equally importantly, when might a longevity swap be favoured over bulk annuity solutions.

Let's first remind ourselves of some of the key differences between the options…

The right tool for the job

A buy-in is where the trustee holds a bulk annuity insurance policy as an asset and remains responsible for paying pensioners. This compares to a buy-out where the liabilities of the entire scheme are transferred to an insurer who then takes over responsibility for the scheme's liabilities. In both cases assets covering the price of the bulk annuity are also transferred to the insurer.

Of course, any scheme with sufficient resources to buy-out the schemes' full liabilities is likely to take that route, so the more interesting decision is whether to buy-in your pensioner liabilities when you remain underfunded on a buy-out basis or keep the backing assets and enter into a longevity swap to transfer the longevity risk.

Over the last year or so bulk annuity pricing has looked attractive when compared to other methods of generating secure income streams – particularly when you are also getting longevity protection for your pensioners in the package.

Certainly, for very small schemes, where access to secure income assets delivering sufficient return may be more limited, there is a strong argument for a buy-in when funding levels and opportunities permit. However, the case for medium and larger schemes seems much more balanced.

A scheme entering a buy-in for its pensioners loses the opportunity to generate additional return from its assets and may be left with a more concentrated risk to match the liabilities of its non-pensioners with the residual assets available. Moreover, for some, retaining the scheme's assets may afford a more balanced investment solution – generating an incremental additional return spread over the whole portfolio.

In addition, those schemes needing to generate higher investment returns than those available from secured income assets alone, or those wanting to do so – for example to preserve profit & loss outcomes under US Generally Accepted Accounting Principles - may well find the option of entering a longevity swap more attractive.

Whilst life expectancy in the UK has not been increasing as fast as previously expected (a fact reinforced by the latest 2018 Continuous Mortality Investigation (CMI) release), longevity risk remains an unrewarded financial risk and one that persists, for most, completely unhedged (compared to interest rate and inflation risks). Moreover, recent history has shown that reinsurer pricing for longevity risk will in time move to reflect the latest CMI projections – so might now be a good time to buy?

Lastly, many schemes are running concentrated longevity risk, with less than 20% of pensioners often accounting for more than 50% of the longevity risk – the very same pensioners who are most likely to live the longest.

Longevity pricing also remains relatively attractive whilst reinsurers benefit from offsetting longevity risk against their substantial books of mortality business.

So, all in all longevity swaps are likely to remain of interest to a number of schemes, but where do captives fit into this picture?

Hit the nail on the head

In short, captives provide the facility for an incorporated cell to be owned directly by the transacting pension scheme, effectively giving the trustee a direct pass-through relationship with the reinsurer and eliminating some of the costs associated with an intermediated structure.

A captive-based solution can be used as a route to, not instead of, a pension buy-in or buy-out. Over the last two years, we have seen a number of schemes in the UK do this – effectively novating the swap structure to the bulk annuity provider who themselves would otherwise seek to reinsure the longevity risk through the same reinsurance market. This is reassuring proof of concept that the lawyers have done their work and longevity swap contracts can be adapted down the line. The British Airways Pension Scheme was the latest to complete such a conversion with its own Guernsey-based contract in 2018.

One of the additional advantages of completing a longevity swap through a captive structure is the flexibility it affords in this scenario – since you only need to negotiate the novation with the reinsurer and bulk annuity provider, as opposed to complex discussions involving an intermediary insurer as well (who, incidentally, may not be as keen to novate if the bulk annuity provider is a direct competitor).

Up until now, captive based or disintermediated longevity swaps have been the preserve of larger schemes, but it seems inevitable that contract sizes will reduce as the contracts are standardised and structures are simplified. Indeed, captive solutions can provide the vehicle to house multiple transactions under an Incorporated Call Company (ICC) and it is only a matter of time before more schemes and providers see the benefit that a captive provides.

So, while they may not be needed by the majority of schemes, captives certainly have a place in the de-risking toolbox and we expect to see them used many times more in the coming years.

Guernsey is the largest captive insurance domicile in Europe and a proven centre for captive-based longevity risk solutions. Indeed, all recent captive-based pension longevity swaps for pension schemes have chosen Guernsey a domicile for their special purpose insurer, utilising the Guernsey ICC in every case.

The island boasts pragmatic licensing and supervision of special purposes insurers, a risk-based solvency regime, and unparalleled breadth and depth of insurance expertise and experience.

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