WRITTEN BY BECKY BUTCHER

INCORPORATED CELLS ARE THE WAY FORWARD FOR PENSION LONGEVITY

11 JULY 2017

Becky Butcher of Captive Insurance Times speaks with Carey Olsen's Christopher Anderson (CA) about Guernsey's significant growth in the use of incorporated cells.

What movement has Carey Olsen seen in longevity risk transfer in Guernsey?

(CA): Carey Olsen was involved in the £16 billion BT Pension Scheme longevity risk transfer in 2014, which was a significant deal for Guernsey. We also act as the legal adviser to the Merchant Navy Officers Pension Fund. In addition, there are two more transactions in the pipeline for a large UK pension fund–similar in size to the BT deal. We are also working on two other longevity deals.

Why has there been so much interest in longevity risk transfer?

(CA): Pension funds with defined benefit (DB) liabilities are looking for options. The pensions industry is concerned about the demographic time bomb and the poor performance of traditional investments in the low-interest rate environment. Both of these trends are making it harder for pension funds to match up their assets and liabilities. A longevity risk transfer is one solution to this issue.

One of the reasons that longevity risk transfer is so interesting is the difference between the needs of pension funds and life insurers and reinsurers. On the one hand, increased life expectancy creates difficulties for DB pension funds because they are obliged to make payments to pensioners over a longer period. On the other hand, increased life expectancy means that life insurers' and reinsurers' liabilities to make payments on death are deferred.

This creates opportunities, especially for a reinsurer with a large book of life business. A longevity risk transfer becomes the perfect hedge for that reinsurer because it can offset the longevity risk against its life business. However, a reinsurer is not licensed to write insurance of a pension fund's risks. That is where the Guernsey cell comes in, as an intermediary between the pension fund and the reinsurer. At Carey Olsen, we have seen quite an appetite for this business.

Where do incorporate cell captives fit into this?

(CA): The incorporated cell of an incorporated cell company (ICC) insures the liabilities of the pension fund and then reinsures its liabilities with the reinsurer. The incorporated cell doesn't retain any net risk. There are significant credit risks in relation to each counterparty, for example, if the reinsurer goes bankrupt, the incorporated cell doesn't get paid. Therefore, an important part of the process is ensuring that there is security and collateral provided, so that in the event of a counterparty failure there is enough capital to unwind everything.

How did the introduction of cell structures in Guernsey change the market?

(CA): By the 1990s, a lot of UK companies that could make use of a captive already had one. The protected cell company (PCC) was introduced in Guernsey in 1997 to enable smaller captive cells to be operated at lower cost. With the introduction of such cell structures, captive insurance became economically viable for a large number of smaller companies.

Why were incorporated cells needed?

(CA): As the name suggests, longevity contracts are designed to ensure over a long period of time. The liabilities of the pension fund can extend for a period in excess of 60 years. A lot can change in that time and so it is important for the parties to have options to migrate, collapse or adjust the structure if necessary. Unlike a protected cell of a PCC, an incorporated cell is a separate company, which makes it much easier to move around, migrate to another jurisdiction or move it to another ICC in Guernsey.

There is also a slightly stronger argument about the segregation of the assets and liabilities of a corporate cell, because an incorporated cell is a separate company and a protected cell isn't. However, PCCs are still more popular in the insurance industry generally, as they are cheaper, easier to manage and more flexible.

Do you think the number of ICCs will catch up with PCCs?

(CA): I think we will continue to see significant growth in the use of Guernsey cell companies in longevity risk transfer transactions. But, I would be surprised if we had as many ICCs as PCCs in five years.

For larger pension funds, it is economically viable for them to set up their own ICC so they can utilise different cells for transactions and reinsurers. However, a number of service providers, such as Willis Towers Watson, Mercer and Artex, have set up their own ICCs which can offer smaller pension funds individual incorporated cells, replicating the PCC structure for captives as described above. This type of setup offers the same solution but at a slightly lower cost.

An original version of this article was first published in Captive Insurance Times' Guernsey Insight, July 2017.

PO Box 655, St Peter Port,
Guernsey, GY1 3PN

+44 (0)1481 720071

INFO@WEAREGUERNSEY.COM

WE ARE GUERNSEY
WE ARE CONNECTED