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THE GUERNSEY ICC LONGEVITY RISK TRANSFER

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2017 has seen Guernsey underline its position as the go-to jurisdiction for longevity risk transfers with the announcement of two further deals, following on from the first ground-breaking deals using the Guernsey 'Incorporated Cell Company' (ICC) in 2014/2015. In IFC Review's Guernsey 2018 supplement, Appleby Partner Kate Storey discusses longevity risk and the merits of the Guernsey ICC.

In summer this year, MMC UK Pension Fund Trustee Limited, the pension fund of Marsh & McLennan Companies, completed the longevity hedge of £3.4 billion in liabilities – covering around 7,500 pension fund members – using the Guernsey-domiciled ICC, Mercer ICC Limited.

Also this year, British Airways' Airways Pension Scheme (APS) is reportedly using its Guernsey captive structure, APS Insurance ICC Limited, to hedge £1.6 billion of liabilities.

Appleby have been advising on this type of deal since the first deals in 2014, from the sponsor side and the pension trustee's side. In our experience it is the Guernsey ICC structure itself that is attracting the business to Guernsey, combined with the fact that Guernsey is the number one captive domicile in Europe.

The longevity problem

The growing level of longevity risk faced by defined benefit pension schemes has been well documented and has led to pension schemes seeking solutions to manage this risk. Such solutions have included pension buy-outs (for example, the General Motors pension buy-out arrangement with Prudential Financial Inc. in 2012), but in the last several years the trend has been towards longevity swap arrangements. Typically in a longevity swap transaction the employer sponsor and/or the trustee of the pension scheme will agree to pay fixed monthly amounts to a financial institution or commercial insurer that in return makes variable monthly payments to the pension trustee. The variable payments are calculated based on the pension amounts that the trustee is obliged to pay to the members of the pension plan. In this way, the risk of members living longer than anticipated (and the liability for pension payments subsequently being more than anticipated) now rests with the financial institution/commercial insurer, which can then enter into a reinsurance arrangement with one or more commercial reinsurers.

However, using insurance intermediaries (commercial insurers and banks) in these risk transfer arrangements has become increasingly expensive. In response to this, in 2014 two ground-breaking longevity swap structures were established in Guernsey using a captive insurance company in place of an insurance intermediary, thereby cutting out intermediary fees and removing the need for price averaging. Price averaging occurs where intermediaries engage with several reinsurers to spread credit and counterparty risks and exposure limits, which inevitably incurs several levels of fees. Instead of engaging in price averaging it is open to the captive to select a single reinsurer at the best pricing available in the market.

The first of these two structures was the BT scheme whereby the trustees of the BT Pension Scheme set up their own captive to transact directly with the reinsurance market, in what is believed to be the largest longevity risk transfer transaction to date, in the form of a £16 billion longevity swap.

The second was the Willis Towers Watson 'Longevity Direct' structure, which extended this captive solution to Willis Towers Watson's pension scheme clients, with the ability for each pension scheme to utilise a separate risk transfer company under the umbrella of the Longevity Direct service platform.

The Guernsey solution – the 'GICC'

All of these Guernsey longevity swap deals to date have utilised a Guernsey incorporated cell company (GICC) as the structure to house the risk transfer vehicle, which is an incorporated cell of the GICC. A GICC has incorporated cells which sit underneath the umbrella of the GICC, but are not subsidiaries of the GICC (rather, they are 'associated companies' of the GICC). The board of directors is the same for the GICC and each of its cells.

Where a GICC is used as the captive of one business (e.g. the BT scheme), each incorporated cell can be used for

a separate hedging transaction of that business. In the case of a platform, the sponsor of the platform may own the shares in the GICC and each client pension scheme owns the shares in a separate incorporated cell of the GICC, which is used to facilitate the hedging transaction(s) for that client.

Why Guernsey?

Guernsey is recognised as the leading captive domicile in Europe and the fourth largest in the world and compared with competitor jurisdictions has the further advantages (as far as business with the UK is concerned) of having the closest proximity to the UK and a special constitutional relationship with the UK, whilst being outside the EU. It pioneered the concept of a protected cell company in 1997 and has always led on innovation in the insurance sector and financial services generally, aided by having a receptive regulator, the Guernsey Financial Services Commission (Commission), which appreciates industry needs for speed of licensing and appropriate, high quality regulation to recognised international standards. Guernsey's insurance legislation is more suited to captive insurance and special purpose insurers than other parts of Europe, given that Guernsey is outside of Solvency II, instead using a risk-based solvency regime in line with IAIS standards.

On top of these advantages, to date Guernsey is the only major captive domicile to offer the incorporated cell company. For example Bermuda 'separate accounts' are not incorporated companies. In 2015 the Cayman Islands introduced the ability to incorporate a portfolio insurance company (PIC) underneath a cell which will take over the insurance business of the cell, but this does not work in the same way as a GICC, and as the PIC must be owned by the Cayman segregated portfolio company on behalf of its cell, the cell owner does not achieve control over the PIC as it does with an incorporated cell of a GICC.

An incorporated cell of a GICC can be hived off into a standalone company separate from the GICC structure. So, in the "rent-a-captive" platform example a client could convert its incorporated cell into a standard company independent from the platform. All of the incorporated cell's assets and liabilities would be automatically transferred to the standalone company by operation of law upon completion of the conversion process. Alternatively, an incorporated cell can be transferred to another GICC.

Each of the GICC and its incorporated cells is separately licensed as an insurer in Guernsey under the Insurance Business (Bailiwick of Guernsey) Law, 2002 (the Guernsey Insurance Law) and therefore separately has to meet the capital resources requirements set by the Commission, although the Commission maintains a discretion to reduce or waive capital and solvency requirements in appropriate cases, for example where the insurance business is fully hedged.

In Guernsey a cell can be established and licensed as an insurer in a matter of weeks rather than months, or on a pre-approved basis with self-certification to the regulator within seven days post-deal if the structure qualifies for the Guernsey special purpose insurer fast track process.

The Commission has a discretion to permit a long term insurer not to appoint an actuary, including where there is a securitisation or reinsurance of longevity related risks where the risk is unlikely to alter significantly following inception of the structure.

Incorporated cell company vs. protected cell company (or standard non-cellular company)

The attraction of an incorporated cell company compared to a protected cell company is that each of the GICC's cells is incorporated and a separate legal entity in itself, which provides an extra layer of ring-fencing of the assets and liabilities in a cell by the fact that it is a separate company from the GICC and its other cells (whereas a protected cell is a segregation of assets and liabilities within the one legal entity of the protected cell company). This has proved particularly attractive to businesses from jurisdictions which do not have cell company legislation and are therefore unfamiliar with the way protected cell segregation works – with an incorporated cell the pension trustees know they are dealing with their own separate company.

Another advantage of a GICC compared with a protected cell company is that incorporated cells, being separate legal entities, can contract with each other and with their GICC (which is not possible for the unincorporated cells of a protected cell company).

The advantages of using a cell in a pre-existing structure as opposed to a standard company are well known in both the captive insurance industry and the insurance linked securities space, producing both time and cost savings.

How the longevity risk transfer works

Once the GICC has incorporated the incorporated cell and the cell has been licensed as an insurer under the Guernsey Insurance Law (which takes considerably less time than setting up and licensing a standalone company), an insurance contract can then be written between the trustee of the pension scheme and its incorporated cell. At the same time a reinsurance contract, mirroring the terms of the insurance contract, is

entered into between the incorporated cell and the chosen reinsurer, so no risk is retained in the cell. The insurance contract and reinsurance contract need not be governed by Guernsey law.

The future

Because of the advantages the GICC model offers and the successful implementation of the various major schemes to date, with the ability to easily and quickly insure and reinsure longevity risk through a ready-made risk transfer platform, it is considered that there is considerable growth potential in this space, made possible by a Guernsey solution.

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WE ARE GUERNSEY is the brand under which Guernsey Finance promotes the island's financial services sector internationally. Guernsey Finance - the promotional agency for the island's finance industry internationally - is a joint industry and Government initiative responsible for the promotion of Guernsey. Under the leadership of Chief Executive Dominic Wheatley, the agency ensures that the core values and competencies of the island's finance sector are accepted and respected by the global community and that financial business development flows are enhanced.

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