LONGEVITY TRANSFER

Advocate Kate Storey, counsel for corporate and commercial at law firm Appleby in Guernsey, discusses how pension schemes are using ICCs to transfer longevity risk

Written by
Kate Storey

Kate Storey counsel for corporate and commercial in Guernsey for law firm Appleby, worked with Towers Watson to set up its own ICC to facilitate longevity swaps for pension scheme clients.

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 more recently 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, the last year has seen two ground-breaking longevity swap structures being 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 its own captive to transact directly with the reinsurance market (The Prudential Insurance Company of America), in what is believed to be the largest longevity risk transfer transaction to date, in the form of a £16bn longevity swap.

The second (on which the author provided the Guernsey legal advice) was the Towers Watson 'Longevity Direct' structure, which extends this captive solution to Towers Watson's pension scheme clients through a form of rent-a-captive.

The solution

Both the BT and the Towers Watson structures utilised a Guernsey incorporated cell company (GICC) as the vehicle for the captive insurance company. So, why Guernsey and why an incorporated cell company as opposed to a protected cell company, or standard company?

Guernsey is recognised as the leading captive domicile in Europe, 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, while being outside the European Union.

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, which appreciates industry needs for speed of licensing and appropriate, high quality regulation to recognised international standards.

Guernsey's insurance legislation and regulations are more suited to captive insurance than other parts of Europe, particularly given it is not seeking Solvency II equivalence and is instead implementing a "captive appropriate" risk-based solvency regime in line with IAIS standards. It has also introduced a possible exemption from audit for captives.

On top of these advantages, to date Guernsey is the only major captive domicile to offer the incorporated cell company. Cayman will shortly introduce the ability to incorporate a portfolio insurance company ("PIC") underneath a cell which will take over the insurance business of the cell.

This does not work however, 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.

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.

This has proved particularly attractive to companies from jurisdictions which do not have cell company legislation. As with a protected cell company, the cells sit underneath the umbrella of the cell company, but are not subsidiaries of the cell company (rather, in the case of incorporated cells, they are 'associated companies' of the GICC).

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

Where a GICC is used as the captive of one company, each incorporated cell can be used for a separate hedging transaction of that company. In the case of a rent-a-captive, the service provider owns the shares in the GICC and each client owns the shares in a separate incorporated cell of the GICC, which is used to facilitate the hedging transaction(s) for that client.

The board of directors is the same for the GICC and each of its cells.

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, as amended (the Guernsey Insurance Law).

Each cell therefore has to meet the capital resources requirements set by the Guernsey Financial Services Commission, although the Commission maintains a discretion to modify capital and solvency requirements in appropriate cases, for example where the insurance business is fully hedged.

A further advantage of a GICC compared with a protected cell company is that an incorporated cell of a GICC can be hived off into a standalone company separate from the GICC structure, although in response to industry demand Guernsey will shortly introduce this facility for protected cells also.

So, in the rent-a-captive example a client could convert its incorporated cell into a standard company independent from the rent-a-captive structure and the cell's insurance licence would automatically transfer over to the standalone company. Alternatively, an incorporated cell can be transferred to another GICC.

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 protected cell companies).

The advantages of using a cell in a pre-existing structure as opposed to a standard company are well known in the captive insurance industry, producing both time and cost savings. In Guernsey a cell can be established and licensed as an insurer in a matter of weeks rather than months.

How it 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 two major schemes to date, with the ability to easily and quickly insure and reinsure longevity risk through a ready-made rent-a-captive structure, it is considered that there is considerable growth potential in this space.