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Buy-ins, Buy-outs

A buy-in or buy-out will exactly match the liabilities a trustee chooses for it to cover. Because of this, it is often seen as the ultimate form of liability matching.



In a nutshell

A “buy-in” or “buy-out” is simply an insurance policy taken out by the trustee. For both, the trustee pays a premium to an insurer.

For a buy-in, the insurer will make scheduled payments (usually monthly) under that policy to match the trustee’s ongoing liabilities. The insurance policy is in the trustee’s name and an asset of the scheme. The trustee and its administrator continue to operate the scheme as usual, but instead of payments of benefits being made from scheme assets, they are funded by payments under an insurance policy.

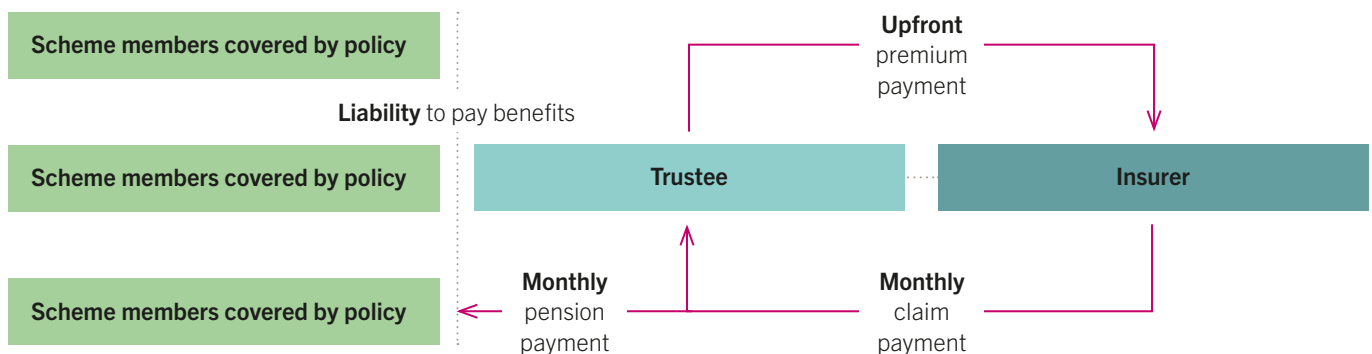
A “buy-out” is an insurance policy where the insurer steps into the shoes of the trustee, and issues individual policies

to scheme members. The members’ benefits are provided directly by the insurer. The trustee is extinguished from liability in respect of those benefits it has bought out. If all benefits are bought out, the scheme usually winds up.

Buy-ins and buy-outs may be referred to as a bulk annuity policy. Buy-in will often precede buy-out, as the process of buy-in is often a temporary period for trustees to get their house in order before pushing the buy-out trigger. Buy-in and buy-out policies can cover the whole scheme; or partial (cover only a select group/category of members).

An illustration of a buy-in is set out below.

Buy-in Diagram



How do you do it?

The initial stages leading up to a buy-in or buy-out can take a long period of time.

The trustee will usually go out to insurers for a quote on the basis of the benefit summary and any key terms the trustee may have for the contract. The trustee will then award exclusivity to an insurer or insurers meaning they will not deal with any other insurer for a set period. In return, the insurer may give some certainty over the pricing terms if the trustee enters into an insurance policy with the insurer by the end of the exclusivity period. During this exclusivity period, the insurer will perform further due diligence on the scheme's data and records.

Once the terms are agreed, the policy can be signed, and the buy-in period starts. If the policy is a buy-out, there is usually a short buy-in period so that everything is in order before the insurer issues individual policies.

In the buy-in period, the insurer and administrator will normally manage the process of reporting on the benefits payable, so the insurer can calculate the amounts due. There is usually a verification or reconciliation of membership data required, often called a "data cleanse", after the start of the buy-in and this can take time to complete. Things that are often checked are members' dates of birth, marital status and address.

What do trustees need to think about when planning a buy-in or buy-out?

Benefit specification

A benefit specification sets out the benefits which are payable under the policy to members. The intention is usually to reflect the scheme's benefits. As members' benefits are governed by the rules in force when they left pensionable service or retired, the trustee and its advisers will need to review historic rules to accurately document what benefits are payable for all members. Some things to note are that:

- > the benefit specification needs to specify the benefits and discretions for all historic members and take account of any enhancements, transfers in and administrative practices;
- > anything not mentioned in the benefit specification or in the contract is not insured;
- > sometimes issues come out of the woodwork once the benefit specification is being prepared, and trustees need to make decisions on what they will ask the insurer to insure; and
- > there is sometimes a difference between what the rules prescribe and what the insurer can provide, and this needs to be managed in advance.

Key areas of negotiation

There are some key areas that trustees will want to concentrate on, and where we see most negotiation when agreeing the insurance policy.

What is insured and what isn't?

- > The trustee and its administrator will need to be sure they know which benefits are being insured, and which members are in scope to receive those benefits.
- > Are any benefits excluded? The trustee will need to be clear as to which benefits it is not insuring or any areas where there is a mismatch between what is provided under the policy and the scheme rules, whether due to administrative ease or otherwise. The trustee will remain responsible for any benefits not effectively discharged by the policy.
- > Benefits may not always be replicated exactly as required under the scheme's rules, and so benefits may be simplified, providing a more generous position, or there may be a mismatch between what is provided under the policy and the scheme rules.
- > For buy-outs, trustees will usually want the best match possible between the policy and the scheme's benefits.
- > If the plan is to wind up and buy-out the entire scheme, the trustee may need to consider how to deal with any risks not dealt with by the buy-out. Options here include run-off insurance or indemnities from the employer.

What options can the insurer provide?

- > Discussions should be had up front about anything unusual, so the insurer can check whether they can facilitate what you want.

Will the trustee need to make an additional payment?

- > If there is a change to benefits or the member data due to the data cleanse, a further premium may be due as these changes may impact on the insurer's pricing. Care will need to be taken to make it clear what benefit changes are included in the price, and which are not. If a member's benefits are discovered to be incorrect and they need to be increased or reduced, how will the insurer do this, and will there be an additional premium?

What happens if the law changes?

- > What happens if the law changes (e.g. like the Lloyds GMP Equalisation case)? Who will bear responsibility for this?

What warranties do you have to give?

- > The trustee will usually warrant as to the accuracy and completeness of the data it is providing to the insurer, and that it has been taken from the administrators' system without amendment.
- > It is important that the trustee can feel it can give the warranties based on the due diligence completed. The trustee will need to work closely with its consultants, advisers and administrators to feel comfortable giving warranties on the basis of the information it has given to the insurer.

Ability to issue individual policies

- > A buy-out occurs when the insurer issues individual policies to the members.
- > The trustee will want to ensure the preparatory work is completed in advance so the buy-out cannot be held up.
- > The trustee will also want to ensure that any individual policies issued provide the trustee with the statutory discharge it needs.

Can the trustee terminate the policy?

- > Buy-in and buy-out contracts will often have limited termination rights, if any.
- > Usually, if the policy terminates, a percentage of the premium is returned to the trustee, with the insurer's margin deducted. Termination triggers could include the trustee's fraudulent and material breach of warranty, or the insurer losing their business licence.

Collateral

- > Collateral is used to mitigate the risk of an insurance company failure which would mean it could not meet the future payments due under the buy-in.
- > Buy-ins can be collateralised. Some larger buy-ins have been collateralised, but there is no market norm here.
- > The trustee will need to consider whether it wants collateral for its buy-in and to recognise the advantages and disadvantages of this.
- > The UK insurance regulatory regime is highly regulated, so trustees may not feel this is needed. Collateral adds complexity and cost to any process.

Longevity Swaps

Under a longevity swap a trustee transfers the risk of its members living longer than expected. It will not always cover other risks such as inflation being higher than expected.



In a nutshell

If a trustee is considering a buy-in, it will often consider a longevity swap. While it is called a longevity swap, this is still usually an insurance policy.

The trustee will enter into an insurance policy with an insurer. The policy will be an asset of the scheme. This is similar to a buy-in, but the only risk the insurance policy covers is longevity.

Should you do a longevity swap instead of a buy-in?

Whether or not a particular set of trustees should go for a buy-in or longevity transaction depends on the circumstances. It depends partly on the long-term objective of the scheme, the trustee's view on what investment returns it is targeting, whether there is an intention to buy-out at some point and the timetable for achieving this.

There are different structural options for a longevity swap

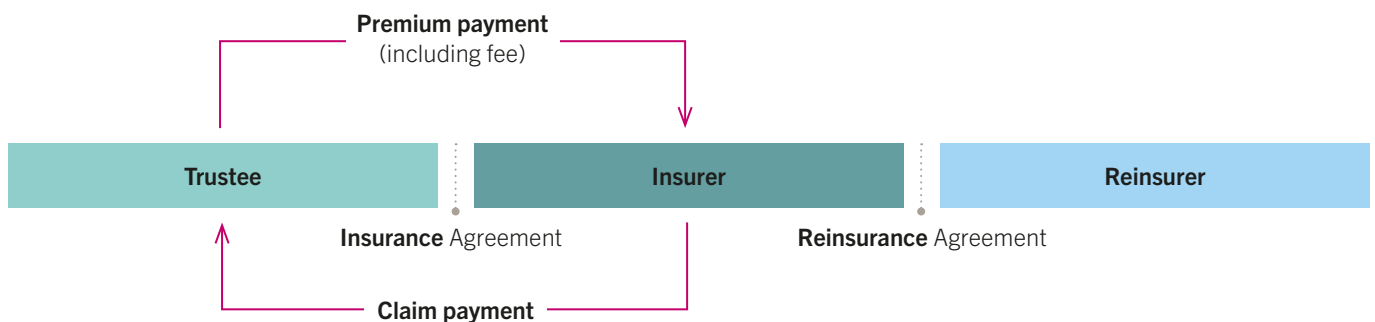
There are currently two main types of structure being used in practice:

- > a fully intermediated structure; and
- > a pass-through structure.

The fully intermediated structure is the "traditional" structure where the trustee enters into an agreement with the insurer and has no visibility over the insurer's own hedging arrangements. Under this structure:

- > the trustee contracts only with a UK insurer;
- > the trustee takes no credit risk on the reinsurers;
- > the reinsurance arrangement can terminate/default with no impact on the trustee contract; and
- > the reinsurer has very limited rights directly impacting the trustee (for example, audit rights).

Longevity Swap Diagram



A pass-through structure or “dis-intermediated” structure is where the insurer acts as a “pass-through” or go-between as far as possible, and the trustee negotiates (and to a certain extent contracts) with the reinsurers as well. Reinsurers do not have the relevant permissions to insure the trustee directly, but this is a way of cutting out the “middle man” as far as possible. The market has developed different options for the trustee to do this, including whether to establish their own “middle man”. This would allow the trustee to directly access re-insurers by establishing its own insurer, which can be onshore, offshore or using a cell company structure.

Under this structure:

- > the insurer does not take credit risk on the trustee or reinsurer (it will be acting in a limited role);
- > the trustee and reinsurer will take credit risk on each other; and
- > care needs to be taken to meet regulatory requirements and ensure the reinsurer is not providing “insurance” to the trustee.

Which structure is best for you?

If trustees are using a longevity swap, they will need to consider which structure suits them best. Issues to think about include:

Regulatory issues these can be complex for pass-through structures;

Contractual issues how complex the contractual documentation will be;

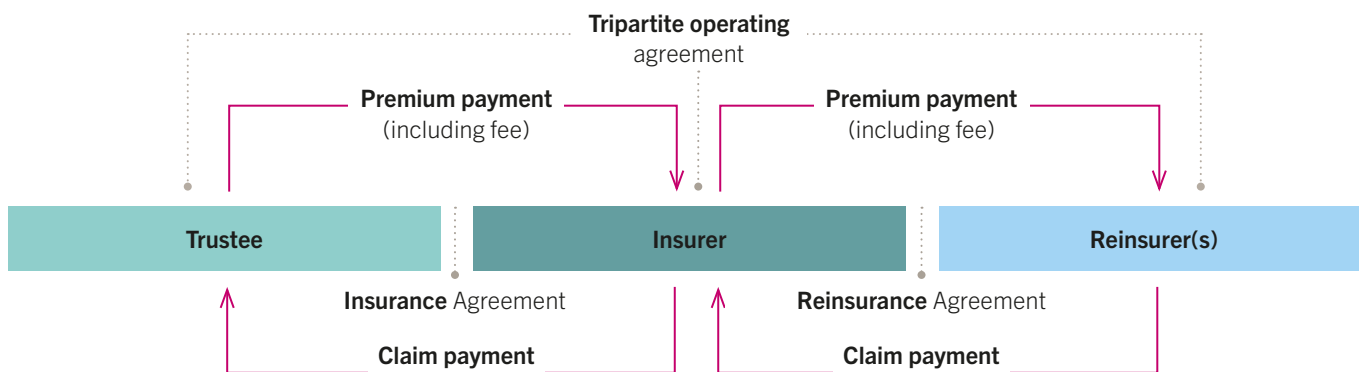
The financial strength of the counterparty; and

Fees the level of fees payable under each arrangement.

Getting ready for a longevity swap

The process for and considerations when entering into a longevity swap are similar to those for a buy-in or buy-out. The main difference is considering how the trustee will deal with the swap if it ever wants to move to a buy-in or a buy-out. The trustee will want to make sure it can retain the flexibility it wants here.

Pass-through Diagram



DB Commercial Consolidators

This “new” option for trustees has a similar effect to a buy-out in that scheme assets are transferred (to another occupational scheme) and the transferring scheme has no further liabilities. However, there are also some key differences.



In a nutshell

DB commercial consolidators are occupational pension schemes that are set up “for profit”. A DB commercial consolidator will take on the assets and liabilities of other defined benefit pension schemes. It is a single employer scheme with no link to the transferring pension scheme (or its sponsoring employers). No benefits are built up whilst in the consolidator’s scheme. The transferring scheme usually has no further liabilities and will wind up.

In this respect, it differs from some existing industry-wide DB consolidators (sometimes referred to as DB master trusts) which take on the liabilities of other defined benefit schemes in order to leverage off economies of scale but also retain a link to the sponsoring employers, and may provide for ongoing accrual. These other consolidators could be described as being a stage further on in end-game planning from fiduciary management but represent an alternative to or even a stage before the kind of DB commercial consolidators discussed in the rest of this article.

How are these different to a “normal” pension scheme?

While they are occupational pension schemes, current commercial consolidator models include a capital buffer which sits outside the scheme.

DB commercial consolidator schemes can be non-sectioned or sectioned.

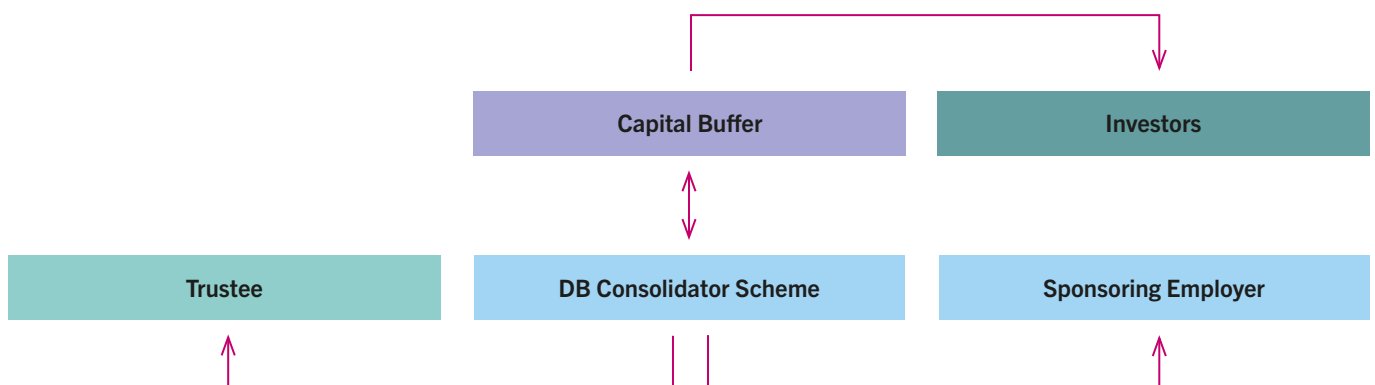
Sectioned means that a section’s assets may only be used for a particular section of the scheme, relating to a single transferred-in scheme (like being a pension scheme within a pension scheme). Non-sectioned means there are no separate sections and there is cross-subsidy between the different schemes which have transferred into the DB consolidator.

How do you transfer to a DB commercial consolidator?

There is a bulk transfer from the existing scheme to the DB consolidator’s scheme using existing legislation which allows this subject to certain conditions.

As part of the transfer, the sponsoring employer of the transferring scheme will pay a fee. Some of this fee will go into the DB consolidator’s scheme to ensure a certain funding level is met and any remaining amount is paid into the capital buffer.

DB Commercial Consolidators Diagram



How are the assets invested?

Like any other pension scheme, the trustee of the DB consolidator scheme controls the investment of the assets. They are currently subject to the same restrictions which apply to other occupational pension schemes and the trustee can delegate its investment decisions like other trustees. The capital buffer does not currently have the same restrictions on investment as it sits outside the scheme.

The Government is proposing that a new regime applies to DB commercial consolidators

The Government had published a consultation on a new legislative framework for the regulation of defined benefit “superfund” consolidator schemes. It closed in February 2019 and we are still waiting for legislation.

The consultation covered three areas:

- > Authorisation: Similar to the regime for defined contribution master trusts, commercial consolidators (referred to as “superfunds”) will be required to seek authorisation from the Pensions Regulator. In order to be authorised, the Pensions Regulator will have to be satisfied that the superfund:
 - > can be effectively supervised;
 - > is run by fit and proper persons;
 - > has effective administration, governance and investment arrangements;
 - > is financially sustainable; and
 - > has contingency plans in place to protect members.
- > Supervision: Superfunds will also be subject to ongoing supervision by the Pensions Regulator.
- > Superfund transactions: The Government is proposing to introduce a “Pensions Regulatory gateway” that

must be satisfied before trustees agree to transfer to a superfund. This will be based on the following principles:

- > schemes that are assessed by the trustees as having the ability to buy-out at the point of transfer would be excluded (buy-out would be assessed “on a basis used by a typical scheme when assessing its ability to buy-out”);
- > schemes assessed by the trustees as being able to afford buy-out in the “foreseeable future” would be excluded (“foreseeable future” is defined as a period up to five years); and
- > for any other scheme looking to transfer, a move to a superfund would need to be based on evidence that it enhances the likelihood of members receiving full benefits.

Trustees will be required to take the following factors into consideration:

- > the scheme’s current funding position on a solvency basis;
- > any deficit reduction contributions;
- > professional covenant advice with a clear conclusion on the employer’s ability to support the scheme for the foreseeable future;
- > actuarial advice regarding the future funding of the scheme; and
- > the funding position and the long-term objective of the superfund.

Trustees will be required to:

- > notify the Pensions Regulator at the earliest available opportunity of their intention to join a superfund;
- > make a declaration to the Pensions Regulator outlining the trustees’ rationale and evidence that the scheme’s transfer to a superfund enhances member security; and
- > if professional covenant advice has not been taken, explain to

the Pensions Regulator why it is not appropriate in their particular circumstances.

The Pensions Regulator will be given powers both to intervene where it identifies that a move to a superfund is not in the members’ best interests, and to prevent the transaction from taking place.

There may also be a requirement that any scheme joining a superfund should be funded to a minimum level upon entry (e.g. 80% of the full buy-out liabilities could be required in order to transfer).

In the meantime, the Pensions Regulator has introduced an interim regulatory regime for assessing and supervising superfunds ahead of a legislative regime being introduced

In a nutshell, the Pensions Regulator expects superfunds to demonstrate that they:

- > are capable of being supervised by their trustees;
- > are run by fit and proper persons with effective governance arrangements in place;
- > are financially sustainable and have adequate contingency plans in place to manage funding level triggers, as well as to ensure an orderly exit from the market; and
- > have sufficient administrative systems and processes in place to ensure they are run effectively.

The Pensions Regulator has also published guidance for trustees and employers considering transferring to a superfund. The guidance says that, before trustees and employers enter into any transaction with a superfund, the Pensions Regulator expects them to demonstrate why they believe the transaction is in the best interests of members, and how the transaction meets the following “gateway

principles” (which are similar to those included in the Government consultation):

- > A transfer to a superfund should only be considered if the scheme cannot afford to buy-out now, and has no realistic prospect of buy-out in the foreseeable future. This will, according to the Pensions Regulator, depend principally on the scheme’s funding level (and how this is expected to progress in the future) and the strength of the employer covenant. The Pensions Regulator says that the “foreseeable future” will be specific to the employer’s circumstances but, in general, will be a period of up to five years.
- > A transfer to the chosen superfund must improve the likelihood of members receiving full benefits. The Pensions Regulator notes that the benefit of transferring to a superfund may be clear in some cases, e.g. where there is an imminent risk of the employer entering insolvency and the scheme’s funding level is significantly below the estimated buy-out funding level. But in other cases, e.g. where the current employer covenant is strong, the merits of the transaction may be more finely balanced.

The Pensions Regulator expects employers to apply for clearance in relation to a transfer to a superfund in most cases. Before it will provide a clearance statement for the transaction, the Pensions Regulator expects trustees to confirm that the gateway principles have been met and to provide the rationale for this view. Where trustees cannot demonstrate the principles have been met, the Pensions Regulator will generally be unable to provide a clearance statement. If clearance is not provided and a transfer to a superfund goes ahead, employers could potentially leave themselves open to the risk of regulatory action.

The Pensions Regulator plans to publish a list of the superfunds which have been assessed and which met the Pensions

Regulator’s expectations at the date of assessment. However, the Pensions Regulator expects trustees to carry out their own due diligence and demonstrate that thorough consideration has been given to their decision. The nature and level of such due diligence will vary and it is a matter for trustees, with input from their advisers, to make a judgement on. However, in general the Pensions Regulator would expect due diligence to include the following:

- > Consideration of other options available to improve the scheme’s position, e.g. whether the wider employer group is able and willing to contribute more.
- > Understanding the scope and timing of the Pensions Regulator’s assessment, including asking the superfund for the summary outcome and making any further enquiries the trustees think necessary. Trustees should also ask whether any material changes have taken place since the date of the assessment.
- > Consideration of whether the destination superfund is right for the members.
- > Consideration of what the superfund is offering, their associated fees (including all transaction and transition costs), their funding and investment objectives, their methods for implementing and achieving those objectives (including their investment management proposal) and the risks to achieving those objectives. Trustees should also consider the information provided on conflicts of interest to ensure they are satisfied with how these are managed.
- > Where member enhancements are being offered, the Pensions Regulator expects trustees to undertake appropriate due diligence of these proposals, including professional advice where appropriate.
- > Consideration of any modelling outcomes that the superfund produces for the scheme.

- > Consideration of whether the transfer is in line with the gateway principles and the risks introduced by the transfer, as well as how the transfer to the superfund results in improved member positions.

- > Consideration of the risks attached to any residual liabilities left in the scheme.

The guidance also says that trustees need to demonstrate in the clearance application that they have considered past significant corporate activity (e.g. mergers and acquisitions or bank refinances) for any material detriment.

What else do trustees need to think about before transferring to a commercial consolidator?

The issues for transferring trustees to think about are not new. They are the same issues as for a scheme merger, but here with a different type of receiving scheme for the trustee to consider.

On any bulk transfer, the trustee will need to ask itself two key questions:

- > Do they have the power to transfer?
- > Should they transfer?

The first question is usually quite easy to answer. This is done by checking the rules to see if they allow the bulk transfer, and if they do, who makes the decision. There usually is a power and it is usually a trustee decision. If there is not a power, normally it is relatively straightforward to amend the rules to allow for this.

The second is a harder, and a much bigger, question to answer.

For practical purposes, the second question for the trustee can generally be considered as: “Is there any reason why the trustee should not agree to the transfer?” This question should be considered in conjunction with professional advice.

Technical legal requirements for the bulk transfer

The transfer needs to satisfy the “employment relationship” condition. This condition is, broadly, that the two schemes relate to persons who have been in employment with the same employer or there is a financial transaction between the employers.

The scheme actuary will also need to provide a certificate to the trustee that benefits provided after the transfer are “broadly no less favourable” and that any established discretionary benefits are maintained in the receiving scheme.

Factors for transferring trustees

Comparison of funding levels

The first factor trustees will look at is how the funding levels compare between the two schemes.

Commonly, comparisons will be done of the two schemes’ funding positions on an agreed date and using the common bases: PPF (s.179), agreed technical provisions, and buy-out.

The commercial consolidators may also have their own funding measure that will need to be taken into account.

There can be difficulties if there is a difference in funding levels. For commercial consolidators, the proposal is that the employer tops-up the funding level in the transferring scheme as it transfers to the DB consolidator. This top-up payment may be held in or outside the receiving scheme.

This mechanism may make funding level comparisons redundant, but trustees will need to understand how much the funding level in the scheme is being improved by this payment.

Trustees will also need to consider whether the consolidator is set up on a sectionalised or unsectionalised basis. This is because this impacts on:

- > what will happen to the funding of the transferring scheme once it is in the receiving scheme;

- > how the funding level (or nature of the scheme) could change in future; and
- > how future transfers-in will impact on the funding.

Covenant supporting the scheme

Covenant is a key element to consider when trustees are deciding whether or not to agree to a transfer out, as it affects the ongoing security offered to members.

When considering a normal bulk transfer, the transferring trustee will assess the employer covenant supporting the receiving scheme (i.e. the strength of the employer with direct responsibility for funding that scheme).

When moving to a DB consolidator, there will not be a traditional employer covenant supporting the receiving scheme. The statutory employer for the purposes of the scheme is likely to be a shell company. The covenant offered here, rather than being by virtue of an employer, will be derived from the initial capital funding of the scheme and any capital that sits behind this.

Trustees will also need to understand how the commercial consolidator’s structure works and how it compares to the support currently offered to the scheme.

Benefits

The trustees of the transferring scheme will be concerned to understand the benefits to be provided to their members under the receiving scheme. The receiving trustees will be concerned to ensure that they understand the benefits to be provided.

Benefits do not have to be identical but ideally best practice is to replicate benefits in the receiving scheme: at the moment, no commercial consolidator is proposing otherwise.

Balance of power

Transferring trustees will be concerned with the balance of power between the trustee and the employer in the receiving scheme (i.e. who has the power to make which decisions). Key powers include employer contributions, rule amendments, winding up and surplus.

Whilst powers do not have to be identical, the transferring scheme trustee will want to ensure that members are not “worse off” because the receiving scheme powers differ from those in the new scheme. This is just one consideration when looking at the transfer as a whole.

Governance and administration

The transferring scheme trustees are sometimes concerned to ensure that there are appropriate arrangements in place in relation to the receiving scheme for the ongoing governance and administration of the receiving scheme. They may want to perform some due diligence here.

Transferring scheme trustees can be concerned with the representation of members and want processes set up so the commercial consolidation listens to member’s views.

Other considerations

End game – what is the DB consolidator intending to do in the long run? Will the scheme run on until the last member dies, or is the intention to target buy-out? This varies and could be something that influences the trustee’s decisions.

If funding worsens – what is the consolidator’s policy to protect members if funding begins to worsen.

Profit – when and how is profit taken out? At what point does this happen? Is it on an annual basis, and what is the measure used to decide whether profit can be taken out? Again, this is something that varies between DB consolidators and trustees will want to understand.

Regulatory regime – what applies to the scheme? Currently, a DB consolidator’s scheme is just treated like any other occupational pension scheme, and it is eligible for the Pension Protection Fund, but regulatory change is on the horizon.

What can be expected in the future?

We are still waiting for the first transactions with the consolidators to go ahead.

Contacts



Claire Petheram

Partner

Tel: +44 20 7456 3676

claire.petheram@linklaters.com



David Phillips

Partner

Tel: +44 20 7456 5215

david.phillips@linklaters.com



Rosalind Knowles

Partner

Tel: +44 20 7456 3710

rosalind.knowles@linklaters.com



Julian Cunningham-Day

Partner

Tel: +44 20 7456 4048

julian.cunningham-day@linklaters.com



Philip Goss

Partner

Tel: +44 20 7456 5604

philip.goss@linklaters.com



John Sheppard

Partner

Tel: +44 20 7456 5998

john.sheppard@linklaters.com



Greg Palmer

Partner

Tel: +44 20 7456 2925

greg.palmer@linklaters.com



Sarah Parkin

Partner

Tel: +44 20 7456 3548

sarah.parkin@linklaters.com



Duncan Barber

Partner

Tel: +44 20 7456 3356

duncan.barber@linklaters.com



Alasdair Smith

Partner

Tel: +44 20 7456 4989

alasdaire.smith@linklaters.com



Edward Chan

Partner

Tel: +44 20 7456 4320

edward.chan@linklaters.com

www.linklaters.com/derisking

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