

Pension funds: hedging longevity risk

Service area / [Insurance](#)

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Longevity risk

Pension funds that operate defined benefit schemes are exposed to longevity risk; the risk that their pensioners live longer than predicted.

Their exposure has been growing rapidly in recent years as life expectancy has increased – just one extra year of additional life expectancy can add 5% to a pension fund's total liabilities.

One solution to this issue is for pension funds to transfer longevity risk to the reinsurance market. Such a transfer can be attractive for both parties.

From the pension fund's perspective, a life reinsurer is often an attractive counterparty, both because of its deep understanding of the nature of the risk being transferred, and because it can provide a balance sheet big enough to assume a meaningful amount of risk from the fund.

The difficulty is that reinsurers are not licensed to directly insure a pension fund's risks.

One option is to interpose a captive insurance company between the pension trustees and the reinsurer.

Guernsey has seen a significant number of transactions which use a special purpose insurance company (SPV), in the form of an incorporated cell, for this very purpose.

How it works

The SPV insures the longevity exposure of the pension fund to its members, and then reinsures those liabilities with a reinsurer. The SPV therefore does not retain any net risk. The pension fund pays premium to the incorporated cell. The SPV pays the premium on to the reinsurer (less its frictional costs) in return for reinsurance of the risk it has assumed.

Each of the counterparties in the transaction is exposed to the credit risk of each of the others. For example, if the reinsurer becomes insolvent, the incorporated cell will not be paid and in turn will be unable to pay the pension fund. This risk is particularly important because of the long duration of the transaction. It can be decades before the pension liabilities are finally run off and the insurance and reinsurance can be terminated.

To protect against this, longevity transactions invariably include extensive security and collateral arrangements.

Incorporated cells

Incorporated cells have been used in all longevity transactions structured through Guernsey to date.

An incorporated cell is a registered legal entity with its own memorandum and articles of incorporation, its own company registration number and its own board of directors. Each incorporated cell is associated with a specific incorporated cell

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company. One of the directors of each incorporated cell must also be a director of the incorporated cell company. In addition, the registered office of the incorporated cell must be the same as that of the incorporated cell company, and the incorporated cell company is responsible for various administrative acts of each of its incorporated cells. Further information about incorporated cells and incorporated cell companies can be found [here](#).

Forming an incorporated cell company is a cost-effective way of establishing a group of special purpose insurers under common ownership (similar to a corporate group comprising non-cellular companies). Once a pension fund establishes an incorporated cell company and an incorporated cell in order to complete its first longevity risk transaction, it can easily add additional incorporated cells at a later date in order to enter into further transactions.

Incorporated cells are flexible at the structural level. They can be transferred between incorporated cell companies, converted into standalone non-cellular companies or migrated to other jurisdictions. This means that the structure can be changed in the future if needed. This is important since, as noted above, a transaction can subsist for a very long time, perhaps in excess of 60 years.

The regulatory regime

Insurers in Guernsey are regulated under the Insurance Business (Bailiwick of Guernsey) Law, 2002, which requires all insurers, including those structured as SPVs, to obtain and maintain a licence from the Guernsey Financial Services Commission. Licensed insurers are subject to statutory capital and solvency requirements. These include a formula-based Minimum Capital Requirement and a risk-based Prescribed Capital Requirement.

However, an incorporated cell used in a longevity risk transfer transaction can qualify as a special purpose entity for regulatory purposes (known as a “category 6 insurer”). This is because its underwriting risk and counterparty credit risk are both effectively eliminated by (in the case of its underwriting risk) the back-to-back reinsurance with the life reinsurer and (in the case of its counterparty credit risk) the collateral and security arrangements mentioned above.

Classification as a special purpose entity means that the incorporated cell does not need to meet either the Minimum Capital Requirement or the Prescribed Capital Requirement. It also does not need to produce an Own Capital Solvency Calculation (or “OSCA”). The OSCA is similar in concept to the UK’s Individual Capital Assessment for insurers.

The Guernsey Financial Services Commission will also waive certain other requirements which would otherwise apply to the incorporated cell:- in particular, the requirement to appoint an actuary to prepare an annual report; the requirement to maintain minimum capital of £250,000; and the requirement

to hold assets representing 90% of policyholder liabilities in trust in Guernsey.

Further details about insurance regulation in Guernsey can be found [here](#).

Management

Instead of employing staff to manage the incorporated cell, the shareholder (the pension trustees) will usually appoint a non-executive board of directors supported by a locally licensed insurance manager. The insurance manager provides administrative services and technical insurance support. It also provides a registered office address and acts as the incorporated cell’s general representative.

Board meetings are held in Guernsey and a majority of the directors are Guernsey residents in order to ensure that the mind, management and control of the incorporated cell remains at all times in Guernsey.

ICC Facilities

Several insurance managers have established their own incorporated cell companies to facilitate longevity risk transfer transactions for their clients.

These managers can offer pension funds an incorporated cell in a ready-made incorporated cell company. These incorporated cell companies may have incorporated cells owned by different pension funds, each of which is established to operate a single longevity risk transfer transaction. This structure can be cost-effective for pension trustees who are contemplating one-off or smaller transactions; and who therefore do not wish to establish their own incorporated cell company.

Substance impact

Early in 2019, the Economic and Financial Affairs Council of the European Union (ECOFIN) reaffirmed that Guernsey is a cooperative jurisdiction with respect to tax good governance. ECOFIN confirmed that not only does Guernsey meet the international standards of tax transparency, the principles of fair taxation and is committed to fighting base erosion and profit shifting but that Guernsey’s tax regime ensures that profits earned by Guernsey companies are commensurate with actual economic substance in the island.

The implementation by Guernsey of tax substance requirements has not had a material impact on the operating models of the vast majority of Guernsey insurers. This is because:

- local regulatory requirements and the expectations of the Guernsey Financial Services Commission have always required insurers to be managed from Guernsey;
- most Guernsey insurers write risks situated outside of Guernsey and so they have always had to be mindful not to

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- conduct insurance business outside of Guernsey; and
- the boards of most Guernsey insurers contain a majority of Guernsey resident directors.

Consequently, the new requirements have not materially affected the manner in which longevity transactions are documented or transacted.

Recent transactions

Carey Olsen has an extensive track record in advising on longevity risk transfer transactions. We acted on the first such transaction involving the BT Pension Scheme in 2014 and have advised on every other Guernsey transaction completed since, as set out below.

- BT (2014) – £16 billion
- Merchant Navy Officers (2015) – £1.5 billion
- British Airways (2017) – £1.6 billion
- Marsh & McLennan UK (2017) – £3.4 billion
- EU Industrial Conglomerate (2018) – £2.3 billion
- Willis (2020) – £1 billion
- Financial services firm A (2020) – in excess of £2 billion
- Financial services firm B (2020) – in excess of £2 billion
- International Industrial (2021) – in excess of £3 billion
- Financial services firm (2021) – in excess of £3 billion
- Financial services firm (2022) – in excess of £3 billion
- Communication services firm (2023) – in excess of £5 billion
- Marsh & McLennan (2023) – £2 billion



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