Removing UK pension exposures through a buy-in transaction

Video Transcript

Intact Financial Corporation announces that the RSA UK Pension Trustees have entered into an agreement with Pension Insurance Corporation plc for Bulk Purchase Annuities with respect to £6.5 billion of RSA UK pension plan liabilities.

February 27, 2023

Louis Marcotte, Executive Vice President & Chief Financial Officer

Good morning. I'm pleased to announce that Intact has reached a significant milestone in further de-risking its balance sheet. Earlier today, the trustees of RSA's two large UK pension plans entered into an agreement with Pension Insurance Corporation, or PIC, to fully insure all associated liabilities through a purchase of buy-in annuities.

Although the press release issued earlier provides a clear overview of the transaction, buy-ins of this size, and offering the significant strategic benefits that this transaction does, are not commonplace. We are therefore using this video to provide more details on the strategic benefits of the buy-in and its financial impact.

Let me first hand it off to Charles to provide context for the transaction and elaborate on the strategic rationale.

Charles Brindamour, Chief Executive Officer

Thanks, Louis.

When we entered into the RSA acquisition, we were comfortable with the UK pension exposure. We've studied it, in fact, for quite some time. These plans had been closed for a number of years, they were well hedged against market risks, partially hedged against longevity risk, and RSA was well advanced in its de-risking journey. We agreed with the Trustees at the time that we would continue to pay £75 million in annual funding contributions, in line with RSA's existing agreement. This provided good visibility over medium-term contribution requirements. At the time, we expected to pay this amount for 7 to 8 years and included these in our cash flows as we calculated the IRR model.

While we were comfortable with the risks involved, it was always clear to me that we would remain opportunistic to de-risk the balance sheet further. In fact, if the cost had been reasonable at the time of the transaction, we would have bought annuities at the moment of closing.

The cost of insuring these plans has since come down significantly on the back of a steep rise in interest rates. As a result, I'm very pleased we were able to secure the buy-in transaction we are announcing today.

We believe this transaction with PIC represents a positive outcome for all stakeholders and we've also worked quite closely with the pension plan trustees throughout the process.

Louis will go through the financial aspects of the transaction shortly, but let me highlight the strategic rationale of this deal.

First, the buy-in will remove all remaining market and longevity risks associated with the plans from our balance sheet. Even though we were comfortable with these risks, the opportunity to eliminate them is too great to pass. This is particularly true given the plans are closed. And, in any event, these risks are not core to Intact's business.

Second, the transaction supports our longstanding ROE outperformance objective by improving capital efficiency. It does this by removing the need to hold approximately £150 million of capital against UK pension risk, as well as removing the pension surplus from our balance sheet. This surplus was generating no return and was therefore dilutive to ROE.

Thirdly, we are eliminating funding contributions of £75 million each year to the plans. In my mind, we are trading an immediate contribution in cash against future cash outflows and trapped capital. I think it's a fair trade-off.

Finally, this transaction gives us more flexibility to capture strategic opportunities over time. We're no longer constrained by the responsibility of managing £6.5 billion of liabilities. This no doubt increases our agility and strengthens our ability to sustainably beat our financial objectives that is to grow Net Operating Income Per Share by 10% annually over time, and to outperform the industry ROE by 500 bps each year.

As well as being the right thing to do for Intact, the buy-in represents a positive outcome for the members of the two RSA pension plans, whose benefits are being secured with PIC – a leading player in this market.

With that, I'll turn it over to Louis, to go over the financial merits of the transaction.

Louis Marcotte, Executive Vice President & Chief Financial Officer
Thanks, Charles.

In simple terms, PIC is assuming total pension liabilities of £6.5 billion against a transfer of assets of the same value. The plans have £6 billion of assets available for transfer, and Intact will contribute approximately £500 million into the plans to bridge the gap.

We will finance the transaction using a combination of excess capital, including the capital released by the transaction, as well as debt, preferred shares and hybrid capital.

The financing is entirely consistent with our capital management strategy. Our regulatory capital ratios will remain in line with operating targets, and well in excess of regulatory requirements. The upfront contribution will result in our adjusted debt-to-total capital increasing by less than 2 points and will remain below 23% at the end of Q1 2023. We expect leverage to return to pre-transaction levels by year-end. We do not expect any impact on our credit ratings.

A word on the mechanics of the transaction.

The annuity purchases are structured as a pension buy-in, under which the plans continue to pay the members directly, while receiving an amount from PIC to cover these payments through a bulk insurance policy. This differs from a buy-out structure, under which individual policies are issued to each member by the insurer, and the plans are terminated.

Therefore, with a buy-in transaction, the remaining risk is essentially counterparty risk. This risk is minimal, in our view. PIC is an A-rated insurer and has significant experience in insuring pension liabilities. And because PIC is a UK-regulated insurer, it is required to maintain sufficient regulatory capital to support annuity payments. And additional security is provided through the Financial Services Compensation Scheme, which is funded by the UK financial services industry, and offers strong protection of members' benefits.

Overall, the buy-in achieves substantially all of our objectives with respect to the UK pension plans. That said, a buy-out transaction is something we will consider in the future. However, a number of steps would have to be completed before the plans would be in a position to do so, and so we cannot comment on the potential timeline or achievability of such a transaction at this stage.

One technicality to note: Approximately £600 million of pension assets will not be immediately transferred to PIC to enable their orderly liquidation. We expect to sell these assets over the next 12-18 months, and the proceeds will be transferred to PIC. We have made prudent assumptions in the valuation of these assets, and have kept some of the excess capital in the UK to absorb potential losses. As such, we do not expect the liquidation to generate any additional financing needs.

Now, let me talk about the financial impacts of the de-risking.

Firstly, we view the upfront contribution of approximately £500 million as being largely equivalent to the sum of the excess capital freed up by the transaction and the present value of the £75 million payments that we are eliminating. Given the strategic and risk return benefits, that's a very compelling reason to complete the buy-in as far as we are concerned. Furthermore, the IRR of the RSA acquisition remains above 20% as the cash flows are roughly equal, though occurring at different times.

The payment of the upfront contribution, as well as the removal of the plans' approximately £200 million accounting surplus, is expected to be recognized as a loss in OCI, and not flow through earnings. From a balance sheet perspective, this will result in a reduction in book value in Q1 2023, which will be partially offset by a favourable adjustment related to the adoption of the new IFRS 17 accounting standard effective on January 1st of this year.

Overall, we expect book value per share to decrease by approximately 5% compared to Q4-2022, after considering both the pension buy-in and the IFRS transition. Given the earnings power of our business, we expect to recover the book value dilution by year-end, assuming our financial performance is consistent with guidance.

On the earnings front, the impact on operating income is minimal at low single digits. Net Operating Income per Share will only be impacted by the financing cost and the foregone income on excess capital used to fund the transaction.

From a tax point of view, the transaction will have a temporary negative impact on the Effective Tax Rate as the deductibility of the contribution is spread over three years and flows through Other comprehensive income (OCI) rather than earnings. This has no effects on the economics of the transaction or our ability to recover tax losses in the future but it will add some volatility in the overall tax rate in the upcoming quarters. Operating effective tax rate is not impacted.

In terms of returns, the transaction will boost our operating Return on Equity by approximately 100 bps going forward, namely by removing trapped capital as Charles laid out earlier.

Finally, I want to reiterate that further de-risking the UK pension plans was in the best interest of all stakeholders. And I am happy that we found an opportunity to execute on a transaction with acceptable financial impacts. I am also pleased that the performance metrics of the RSA acquisition remain in line with prior guidance, including our three-year NOIPS accretion target of 20%.

With that, I will turn it back to Charles for his closing remarks.

Charles Brindamour, Chief Executive Officer

Thanks, Louis.

Let me wrap up by reiterating the compelling strategic merits of the buy-in agreement with PIC.

1. The transaction virtually eliminates our exposure to UK pension risk.
2. It does so at a cost broadly representing the acceleration of future contributions and released capital.
3. The NOIPS impact is expected to be minimal as Louis stated
4. It enhances the ROE profile of our business by improving capital efficiency, and finally
5. It gives us greater flexibility to deploy capital in growth opportunities.

As a result, we are now better positioned to pursue our two financial objectives. To outperform the industry ROE by 500 bps, and to grow net operating income per share by 10% per year over time.

Thank you.