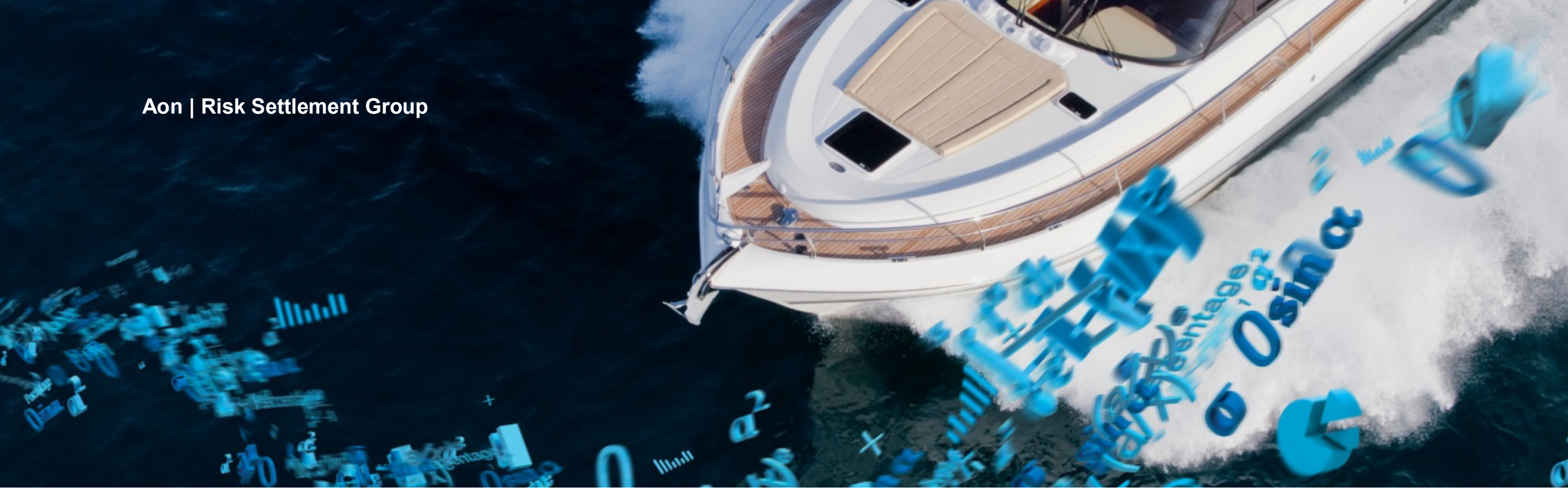


UK Risk Settlement

September 2018

New highs for the annuity market

Bulk annuity market volumes reached record levels in the first half of 2018, as reported in our UK Market Update in August, and then accelerated further over the summer.

Of eight bulk annuity providers, Phoenix Life have completed their first external bulk annuity deal this year and six of the other providers have completed their largest ever transaction this year.

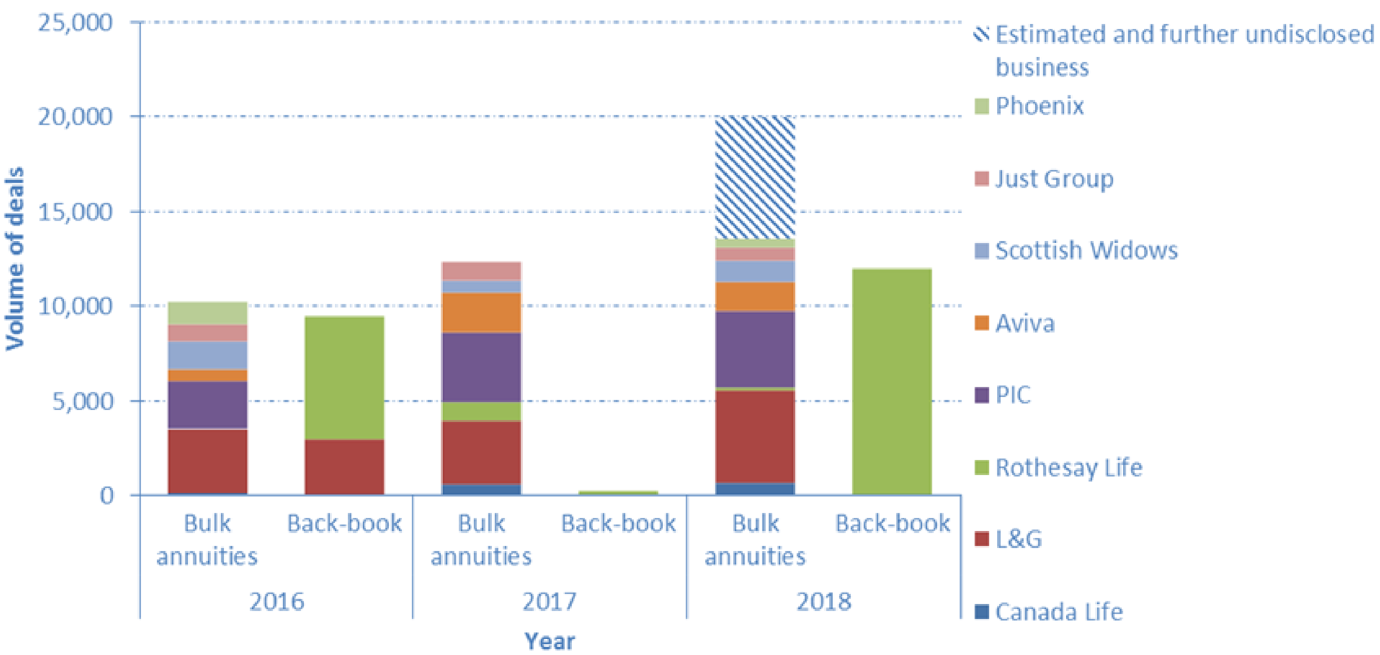
This reflects excess supply carried over from 2017, plus advance planning for large transactions that then progressed over 2018, with more assets and capital lined up by insurers to take them on than in previous years. Activity has peaked over the summer, with a particularly large volume of business being placed or entering exclusivity between June and September.

As 2018 began, we predicted that this would be a record year for bulk annuities and that £30bn of risk could be transferred by the end of the year.

Disclosed business so far is now over £25bn, including the £12bn Prudential bulk annuity back-book won by Rothesay Life (the largest transaction to date), the £4.4bn pensioner buy-in for British Airways with Legal & General (the largest deal with a pension scheme) and a series of further substantial transactions, with more to be disclosed subsequently.

The charts below show the volume of business over the last three years split out between bulk annuity business and back-book deals.

Bulk annuity business written with UK pension schemes £M



Excellent pricing has been available for pensioner and full-scheme buy-outs that we have placed, with the market able to absorb larger transaction sizes than before without a diminution in the yield our clients have captured.

The extra capacity generated is a material step forward in providing a market that can cope with the increasing maturity of defined benefit pension schemes in the coming years. In the very short-term, the market's free people and asset capacity will be temporarily constrained while the recent wins are digested.

The market is then expected to have material capacity for absorbing new deals into 2019, and fundamentals that have driven strong pricing – such as illiquid asset opportunities for insurers and competitive longevity reinsurance – should remain. However, preparation will be critical to compete against the wider interest from schemes that recent pricing has attracted, and the best time to start planning is now.

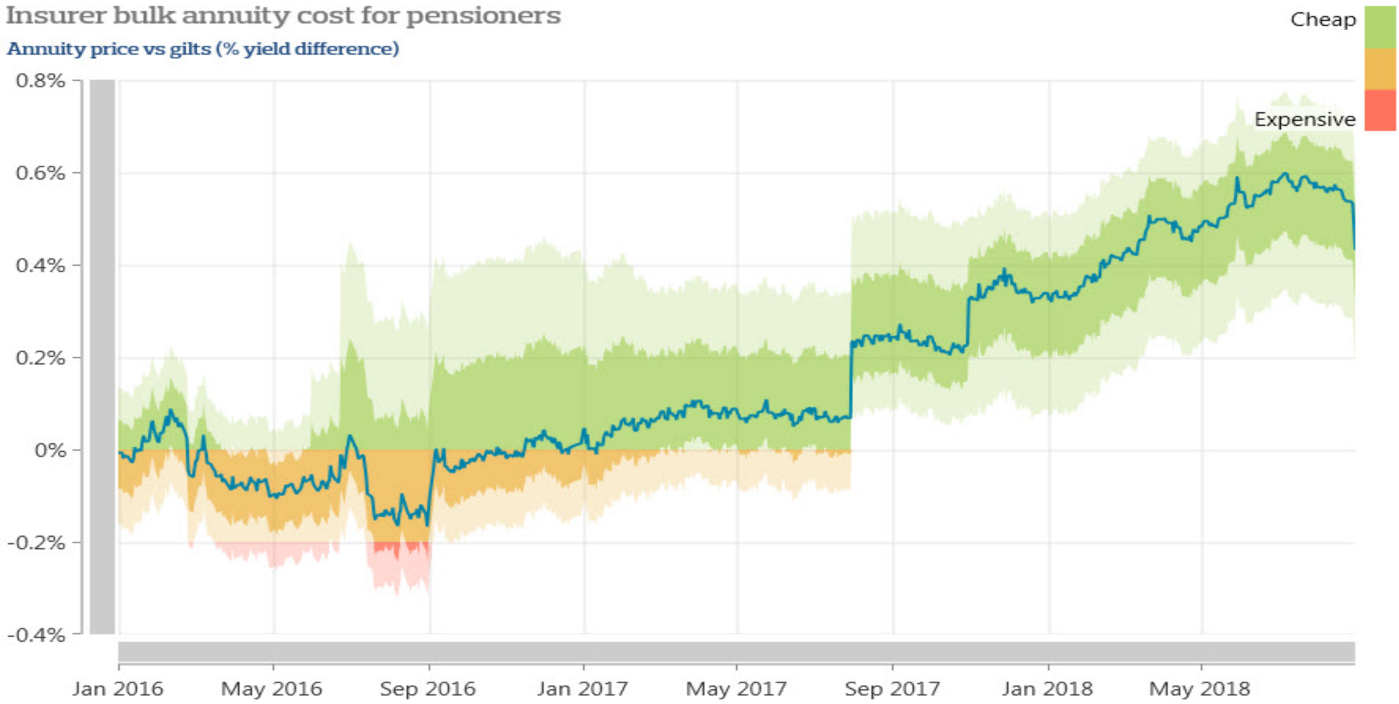
Annuity yields relative to gilts

The chart below shows the implied return on a pensioner buy-in relative to gilts since the beginning of 2016 - the point at which the Solvency II insurance regime came into force.

After a short period of "bedding-in" and the market disruption caused by the Brexit Referendum in June 2016, the yield on an annuity showed a continued improvement up to summer 2018.

These pricing improvements seen in 2018 are not just down to actions taken by insurers. The upwards trend in implied yield on an annuity, when assessed relative to gilts, has been helped by the diverging metrics used by insurers and pension schemes to value liabilities, as reported in previous Bulletins.

The partial drop off in pricing at the end of August 2018 reflects the lack of capacity in the current market, following the deals referred to earlier in this Bulletin. This may be reversed for 2019 transactions.



How to read this chart

- This shows the return from a bulk annuity for pensioners, relative to the yield on a comparable gilt portfolio, assuming insurer-type assumptions beyond the discount rate
- Annuities shown as 'Cheap' if giving a better return than gilts
- This comparison ignores the material value from annuities giving a better hedge including longevity cover
- Expected pricing for a typical scheme is shown by the blue line
- Best prices typically fall in the darker shading, some auctions fall in the lighter shading. Pricing outside the shading typically represents an unusual liability profile

Chart sourced from Aon's Risk Analyzer

Equity release mortgages in the spotlight

Equity release mortgages (ERMs) represent a long-term loan, usually repaid by the sale of the property on death. A diversified book of ERMs can provide a long-term income stream, potentially giving a reasonable match to pension pay-outs under annuities, and in recent market conditions, an attractive yield to insurers. The ERM market has grown quickly, and they have recently been the fastest growing asset class in annuity portfolios, with their yield one of several contributors to favourable annuity prices.

However the reserving requirements for default risk on ERM holdings are under review in a consultation launched by the Prudential Regulation Authority (PRA) in July. The outcome is expected in late 2018.

The key feature of ERMs of concern is the NNEG (or "no-negative equity guarantee") that most carry. This guarantee ensures that the borrower will not need to repay more than the house value on death. This creates a risk to the insurer, in particular if the house price suffers a substantial lasting fall, to less than the amount borrowed plus interest (interest is normally added to the mortgage outstanding). This risk is hence linked to longevity and house prices.

While this guarantee has seldom bitten to date, and a typical ERM backing an annuity may only represent a loan of around 30% of the house value at outset, a longer-term exposure is created. Insurers already reserve for downside risk on this exposure, but the question is just how big the relevant contingency margin should be.

Aviva, L&G and Just Group are the leading writers in the ERM market, and Just has a comparatively high proportion of its annuity book, backed by ERMs (36.5% at 30 June 2018).

Although Just Group have explained that their existing reserves contain material contingency margins relative to actual experience, and that they have several ways of releasing or raising capital if a higher reserving requirement is demanded from 31 December, their share price has suffered given the uncertainty created.

The annuity market's reaction has been a slight worsening of pricing as new deals become backed to a greater extent by alternative long-term assets such as infrastructure debt.

We distinguish:

- The long-term risk of house prices actually performing so badly that these guarantees eventually bite regularly.
- The much higher probability of a material increase in reserving to add more tail-risk protection. This appears likely to happen, but to what degree is not known. If the guarantees continue not to bite in practice, the extra capital held back will be released over time. However the cost of obtaining and holding it must be met.

All of the modern-day bulk annuity providers are substantial insurance companies with large asset pools under management. However the market could see more consolidation in future, particularly if the regulatory environment continues to be changeable. This tends to produce a positive outcome for policy-holders, as annuity books of different insurers can only be combined through a careful process that maintains or improves their position.

Hence the PRA's consultation will be important for considering the asset strategy backing new annuity deals in 2019.

Consolidation vehicles

A hotly debated topic is the scope for sponsors to pass on responsibility for their defined benefit pension liabilities without meeting the cost of annuities.

The Government has indicated that it will consult by the end of 2018 on a legislative framework and authorisation regime within which new forms of consolidation vehicles could operate.

The pensions market already includes some options to gain economies of scale, through for example multi-employer schemes or shared asset management platforms.

However, the consultation is expected to focus on 'Commercial Consolidators': non-insurance vehicles which enable the sponsor to discharge their liabilities, subject to a minimum level of funding on entry.

These arrangements are expected to operate as occupational pension schemes, and so be subject to the potentially less onerous scheme funding regime, rather than the solvency regime applicable to insurance companies.

Two firms have publicly announced their offering – The Pensions Superfund ("PSF") and Clara. Both firms rely on capital provided by investors to provide security for the pension liabilities. PSF plan to act as a long-term run-off vehicle, combining all incoming assets and liabilities into one pool, with profits emerging based on improvements in the funding position achieved.

Clara is instead a transitional vehicle, managing schemes in individual ring-fenced sections for a temporary period while they mature sufficiently to buyout the liabilities of the section in the insurance market, at which point capital and profit is returned to investors.

Both firms are seeking to engage a well-respected trustee board and management team, although in recent weeks PSF have seen the departure of their CEO, Alan Rubenstein, and head of origination, Marc Hommel.

Entering a commercial consolidator will require trustee agreement, although in many cases the possibility is likely to be raised by the sponsor in the first instance. Trustees will need to be convinced of the financial strength and governance capability of the consolidator, and that overall entering the consolidator represents a better outcome for members than relying on the existing covenant. Generally speaking they may be more attractive to schemes where the sponsor's covenant is weaker or uncertain.

There were previous attempts to launch consolidator schemes when the bulk annuity market expanded around 2007, but without success. The greater maturity of typical final salary schemes now, plus a political will to derive an acceptable legislative framework and authorisation regime for consolidation vehicles to operate in, may make them more successful than before.

In practice they will need to build scale and momentum quickly in order to be seen as a credible alternative route for schemes and to retain the interest of their financial backers (one private equity firm behind PSF, Warburg Pincus, recently announced they will not continue to invest at this stage).

Should the consolidators prove to be successful, providers of other pension solutions may seek to move into this space to avoid losing market share.

Given the sheer volume of defined benefit liabilities to be addressed (estimated to be over £2 trillion, hence a hundred times even 2018's peak expected bulk annuity volume), this is not expected to threaten the growth of the bulk annuity market notably. We still expect buy-out to be the natural target for the majority of pension schemes as they mature further.

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