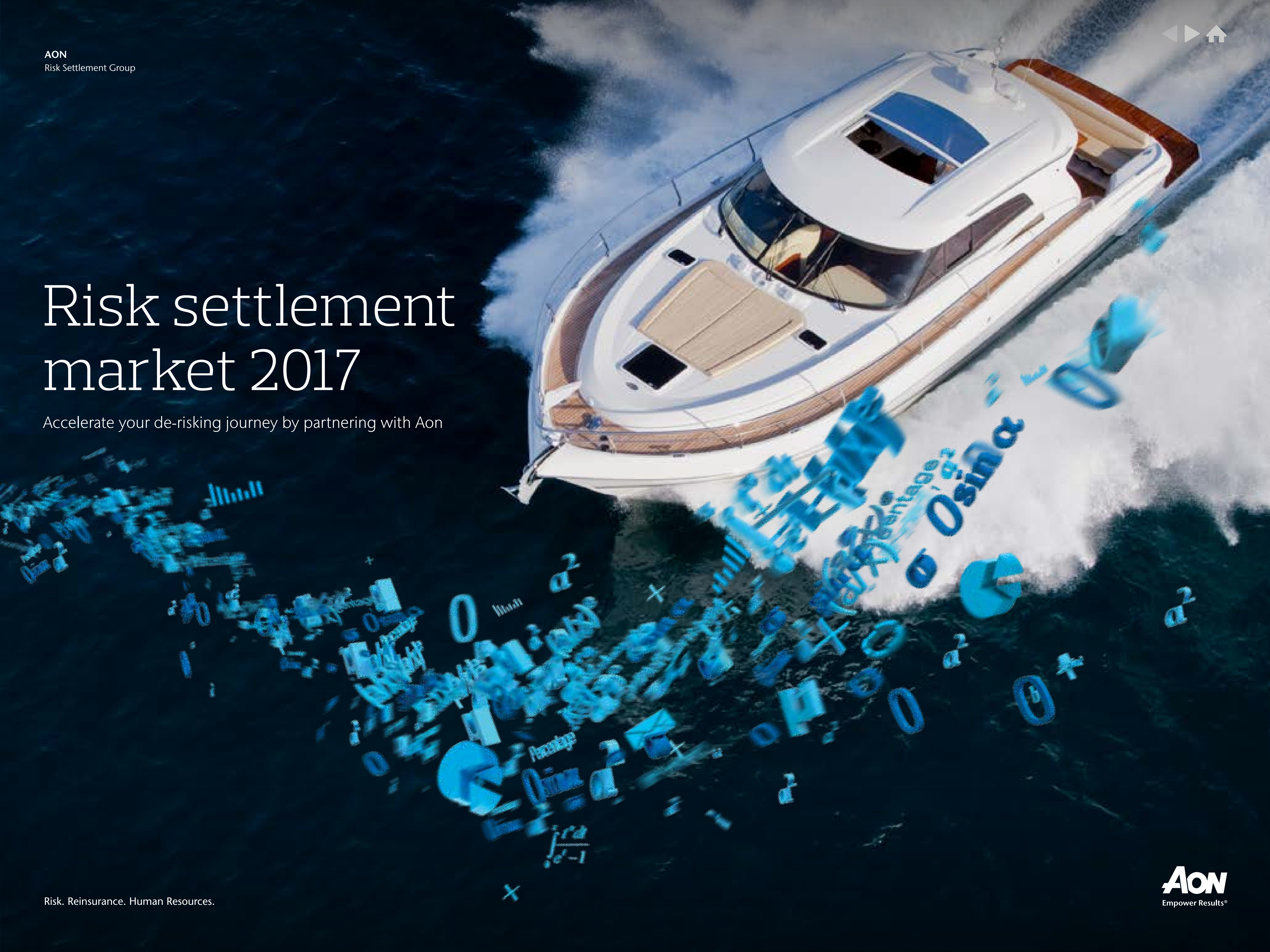


Risk settlement market 2017

Accelerate your de-risking journey by partnering with Aon

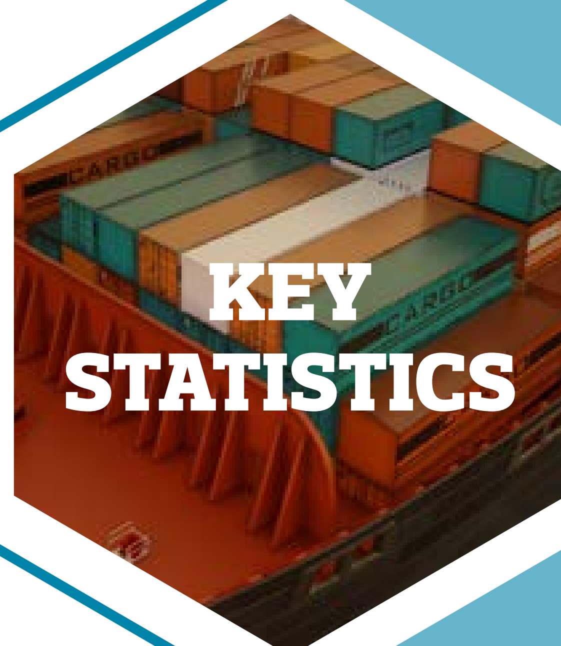
Risk. Reinsurance. Human Resources.

Aon
Empower Results®

Over
£20bn
of risk transferred to bulk annuity and longevity swap providers

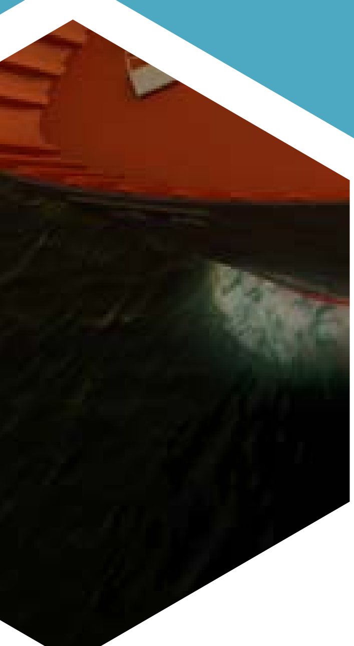
Aon offers bulk annuity and longevity swap solutions for schemes of all sizes

Aon leads advice on the first longevity swap to bulk annuity conversion



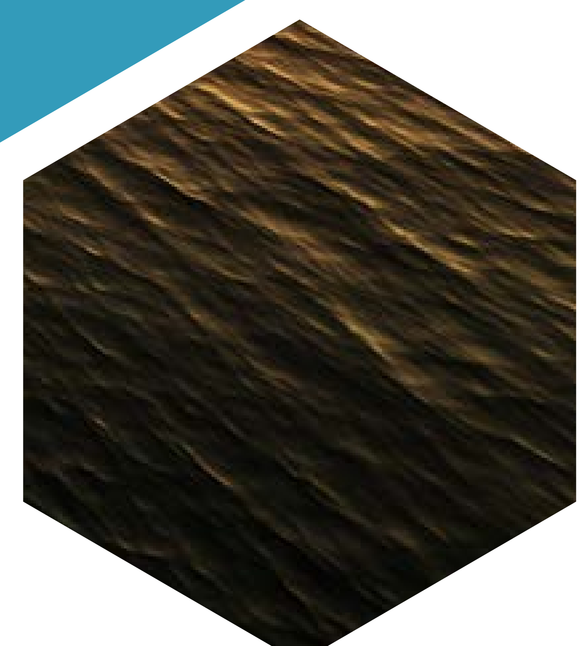
KEY STATISTICS

A trend towards tranched bulk annuity purchase



10+
risk takers in the longevity hedging market

7
bulk annuity providers actively pricing



2016: A year of challenges and opportunities

Bulk annuity business volumes exceed
£19bn
for the first time ever

Bulk annuities offering big opportunities

It has been the most significant year to date for the UK bulk annuity market, with business volumes exceeding £19bn for the first time ever. Insurers proved that buy-ins and buy-outs can be achievable and attractive following the introduction of the Solvency II regime at the start of the year. Market volatility, following the outcome of the EU referendum, also presented a number of opportunities for clients to capture attractive bulk annuity pricing with a flurry of transactions closing in the second half of the year.

Longevity swaps: market opens up to small transactions

In the longevity market, it was a different story. Emerging deaths data and low gilt yields presented pricing challenges over the course of 2016 for pension schemes looking to transfer risk. There were a couple of notable highlights. The market firmly opened up to smaller transactions, with the smallest deal to date covering £50m of liabilities, and the first ever longevity swap to bulk annuity conversion took place. Further, appetite from UK insurers looking to transfer longevity risk in 2016 remained buoyant throughout the year, given the capital efficiency benefits under Solvency II.

Highlights for Aon

Lead adviser on the
£1.2bn
bulk annuity transaction for Phoenix Group in 2016.

Led advice on a landmark case that featured the first longevity swap conversion to an annuity.

Completing a significant pensioner buy-in covering
£900m
of liabilities for the Aon Retirement Plan in 2016.

Leading advice on more than a third of the deals placed in the bulk annuities market in 2016. (by value)

Demonstrating our commitment to securing the best outcomes for clients by highlighting the dislocation between reinsurance pricing and the latest trends in mortality.

Launch of Aon's Bulk Annuity Compass Platform, our complete bulk annuity service, enabling schemes to capture market opportunities quickly and effectively.

Optimising value on repeat transactions in 2016 and early 2017 for Smiths Group (£250m and £130m), Alcatel-Lucent (£100m), Pilkington (£230m) and CAA (£90m).

2017: Time for schemes to react?

Be prepared for better prices

As with the end of 2016, given resource and capacity constraints, pension schemes looking to complete bulk annuity or longevity transactions in 2017 will need to ensure they are well prepared to be at the front of the queue for pricing. This will involve completing the necessary groundwork before going to market, including upfront data and benefits preparation, and the establishment of a clear decision making framework with the engagement of all the key stakeholders.

For schemes further away from a transaction, early preparation can help to ensure that, when the time is right, market opportunities can be captured quickly and effectively. Liability management exercises or flexible retirement options can be a great way to help accelerate your de-risking journey and step closer towards a buy-in or buy-out target.

Breaking the £20bn barrier?

With insurers boosting their teams in anticipation of a bumper year, 2017 could well be the year the bulk annuity market reaches deal volumes in excess of £20bn. In the longevity market, we are starting to see promising signs that emerging deaths data is feeding through to pricing, meaning 2017 has the potential to be a significant year for the longevity market as well.

For more information on how Aon can help you to accelerate your de-risking journey and capture attractive market opportunities, please get in touch with one of our Settlement Advisers or your usual Aon contact.

Further information can also be found on our website:

http://www.aonhewitt.co.uk/risksettlement

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Bulk Annuities

The UK bulk annuity market in 2016

Read more

Eight reasons to complete a tranched buy-in strategy

Read more

Is there still demand for medically underwritten annuities?

Read more

Member options: helping prepare your benefits for settlement

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Get the best value in the market: Bulk Annuity Compass

Read more

Right approach, big benefits: why we launched Bulk Annuity Compass

Read more

The UK bulk annuity market in 2016

Key points

- The market reached a record level in 2016, with business volumes exceeding £19bn
- Over 80% of the risk insured in 2016 was transferred by just five companies
- Volumes are expected to reach similar levels in 2017, with continued focus on securing tranches

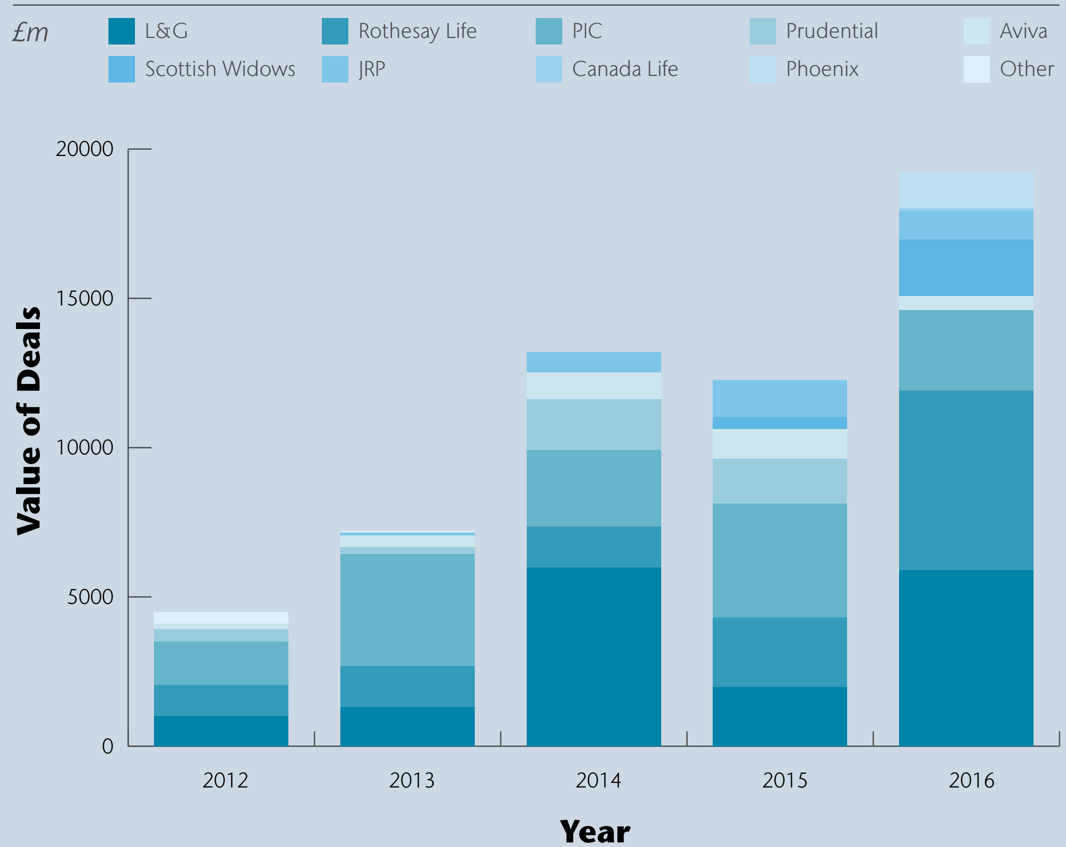
Resilience in a time of change

The bulk annuity market has seen substantial change recently, but proved resilient as demand for de-risking continues to grow.

2016 saw large transactions and strong price opportunities. There were significant innovations and initiatives behind the scenes as providers redesigned their offerings to remain competitive.

Overall, £19.7bn was written in new bulk annuity deals disclosed, comfortably a new market peak. However, almost half of this was taken up by insurers buying 'backbooks' of annuities from other insurers as bulk deals (such as the £9bn Aegon portfolio shared between Rothesay Life and Legal & General). The remainder represents de-risking of company pension schemes.

Bulk annuity business written with UK pension schemes



JRP data includes business written as Just Retirement and Partnership.

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All change – the Solvency II shake-up

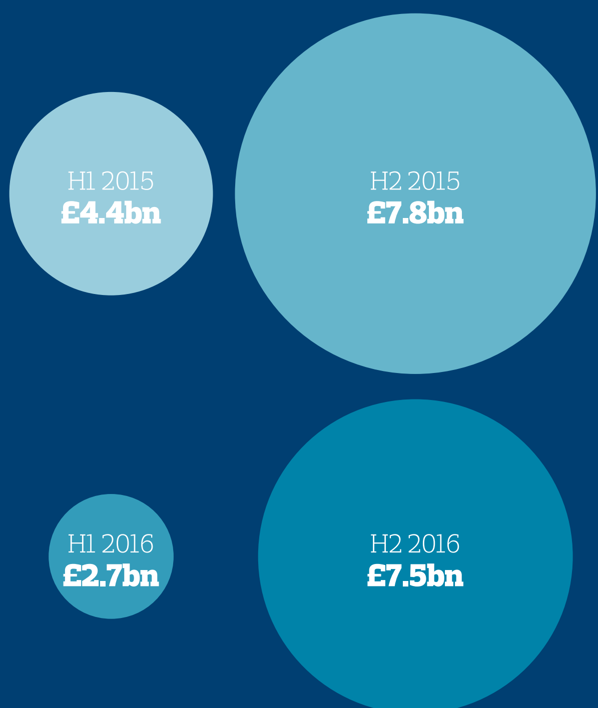
The change in solvency requirements from January 2016 triggered significant changes to asset and reinsurance strategy for annuities – and materially increased the reserves needed. Some insurers, notably Prudential, pulled out of the bulk annuity market. Just Retirement and Partnership merged for scale (to become Just as part of the JRP Group) and some bulk annuity product launches were put on hold. Such changes have left the door open for newer entrants to establish themselves. Scottish Widows in particular carved out a healthy market share in its first full year writing bulk annuities.

Most annuities are now written by the focused group of firms shown in the the table below. Auctions continue to be tightly fought over, but questions remain over future market capacity which could potentially top £20bn in 2017.

	Bulk annuities	Individual annuities
Aviva	Y	Y
Canada Life	Y	Y
JRP	Y	Y
L&G	Y	Y
PIC	Y	–
Retirement Advantage	–	Y
Rothesay Life	Y	–
Scottish Widows	Y	Y

2016 was a period of adjustment, with fewer annuities written until the summer as providers tested their pricing to see if their asset opportunities were strong enough to deliver winning bids. This allowed time for pent-up demand from schemes to develop, with well-prepared schemes securing some attractive prices as the annuity market sought to grow again.

UK pension scheme buy-in and buy-out deals completed over 2015 and 2016



Annuity providers took time to develop attractive pricing opportunities in 2016

Flex for success

Market capacity continues to be tested – not in terms of asset availability or reinsurance capacity, but in skilled manpower. Providers have struggled at times to meet the interest for quotations from schemes and so increasingly consider their 'win probability' when deciding which deals to prioritise.

Large deals continue to take up most of the market's capacity, creating constraints for winners and sudden price opportunities for those with assets to spare. To secure an annuity in this environment, flexibility to respond to changing market opportunities is important.

Back for more

Aside from backbooks, it is noticeable that most of the bulk annuity business placed recently relates to repeat buyers in the settlement market.

These include companies whose schemes conducted at least two-thirds of the bulk annuity business in 2016 – including Aon, Alcatel-Lucent, GKN, ICI, Pilkington, Rolls Royce, and the Smiths Group. This shows how confidence in de-risking can grow considerably following the first transaction and also demonstrates that closely monitoring the market enables a quick response to favourable pricing.

Over 75% of the risk insured in 2016 was transferred by just 5 companies

- £9bn of **Aegon** backbook business placed with Rothesay Life and Legal & General
- Substantial transactions for **Phoenix Group** (£1.2bn) and **Rolls Royce** (£1.1bn)
- Pensioner liabilities of £900m secured from **Aon**'s own pension arrangements
- A series of transactions for **ICI** schemes with Legal & General, Scottish Widows and PIC, totaling £2.7bn in 2016

Appetite for small deals

The actual number of deals placed from company pension schemes (175 in 2015 falling to 109 in 2016) tells a different story about the bulk annuity market. Aviva, the JRP Group and L&G continue to write a lot of transactions under £20M, with Canada Life also offering smaller pensioner transactions. This market sector represents most bulk annuity deals placed.

The future: don't get caught in the rush.

Many final salary schemes are yet to secure a bulk annuity but most are expected to be fully bought out eventually. A dramatic rise in demand for annuities may arise in particular market conditions, for example a sustained improvement in yields. Accordingly, being sufficiently flexible and nimble to capture available market capacity has become a key theme.

Employers with de-risked final salary schemes have a competitive advantage in removing a source of financial volatility. The challenges of sponsoring a scheme have been increasingly highlighted, for example in coverage of British Steel and of the BHS and Bernard Matthews insolvency arrangements.

While the Government continues to consider whether pension legislation can now be eased after much strengthening since the 1970s, we still expect the flow of liabilities to the bulk annuity market to continue to rise as schemes mature.

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Is there still demand for medically underwritten annuities?

Key points

- Underwriting the concentrated risks through 'top-slicing' continues to deliver funding improvements
- Post-deal underwriting offers an opportunity for competitive pricing
- Market for underwritten annuities is expected to grow in 2017 following an unsettled year

The merger of the two most active providers in the underwritten market, Just Retirement and Partnership to form 'Just', undoubtedly raised concerns of reduced competition, with some commentators even suggesting that this was the beginning of the end for enhanced bulk annuities. But developments suggest that there is still a place for medically underwritten annuities.

Is the underwritten model still viable?

We believe that underwriting individual members continues to produce beneficial pricing, particularly for members with larger liabilities who are going to be priced conservatively using a conventional basis. The value added from using medical data has, in some instances, helped to improve funding positions well beyond what is achievable in the traditional market.

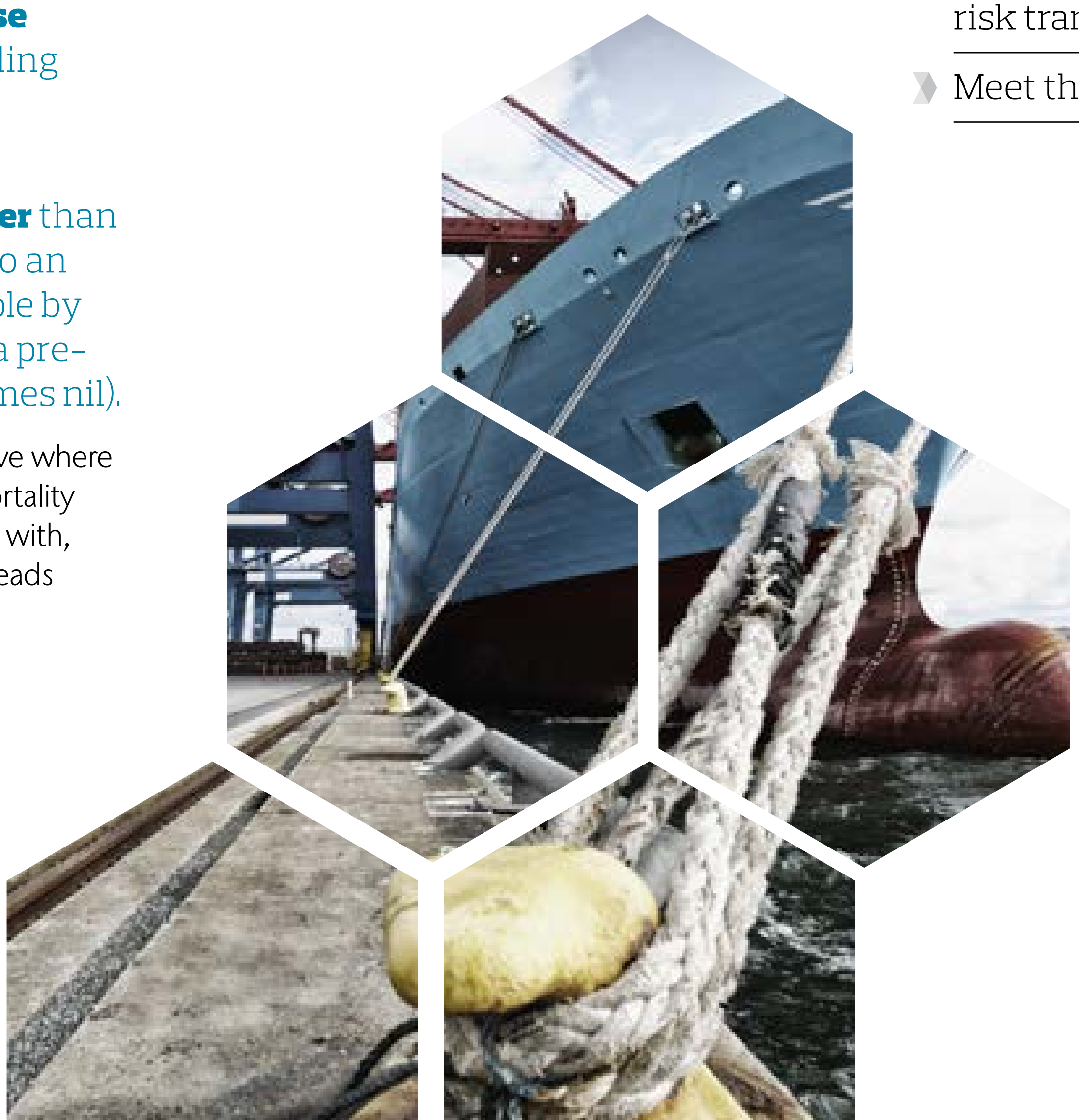
Aon has also demonstrated that competition does exist, having placed the first deal with a provider that was not Just with the £230m underwritten buy-in of Kingfisher with Legal & General.

Underwriting evolves for competitive auctions?

2016 saw the emergence of 'post-deal underwriting' to allow Just to compete in traditional auctions. Under this structure a transaction is completed first, and the scheme membership is underwritten afterwards. The influence of medical data can have two outcomes:

1. Health of population is **worse** than initially assumed, leading to a rebate being payable to the scheme
2. Health of population is **better** than initially assumed, leading to an increase to premium payable by the scheme, but capped to a pre-agreed maximum (sometimes nil).

This contract structure is very attractive where the insurer premium on 'average' mortality assumptions was competitive to start with, particularly if the capped maximum leads the auction.



What next for underwritten bulk annuities in 2017?

The success of this market's immediate future will depend on a number of things, including the competitiveness of Just and the asset opportunities they generate; the activeness of other participants, in particular Aviva and Legal & General's willingness to provide quotations in multi-insurer underwritten exercises, or the establishment of new entrants; and the development of alternative contract structures, such as post-deal underwriting.

Overall, after the slow start to 2016 due to the Just merger and the market-wide implications of Solvency II, we anticipate the underwritten market to build on a strong finish to 2016 and deliver growth in 2017.

"This is another important step for the Kingfisher Pension Scheme on its journey towards a target of self-sufficiency by 2030. The annuity provides a further improvement to the financial security of the scheme for all members."

Clive Gilchrist
Chair of Trustees, Kingfisher Pension Scheme

The £230m pensioner buy-in of the **Kingfisher Pension Scheme** with Legal & General is the **largest medically underwritten bulk annuity** to date. Here are some of the key features.

- Aon helped to identify an opportunity to transact at a cost lower than funding liabilities, with **improved return on assets**
- **Removed financial and demographic risks** associated with largest and riskiest pensioner liabilities
- Established a strong sub-committee with support from both trustee and company and focused on **clearly defined goals**
- AHEAD data collection service achieved 80%+ member response rate – more than 10% **higher than the market average**
- Medical information supported pricing materially lower than traditional pricing
- **Innovative price lock** was negotiated giving additional certainty
- Pre-negotiated Pathway contracts **significantly reduced transaction time** allowing the trustee to fully capitalise the pricing opportunity

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Get the best value in the market with Bulk Annuity Compass

Key points

- Ensure opportunities are not missed, by monitoring and engaging with the market at the right time
- Our tried and tested approach is delivering measurable value when de-risking
- Don't take our word for it – see how Alcatel-Lucent benefitted from using Bulk Annuity Compass

Bulk annuity pricing is volatile. Investment opportunities, regulatory requirements, access to capital, underlying economic conditions, and supply/demand issues are all having an impact on the premium that schemes could ultimately pay. Against this background it is no surprise that trustees can feel overwhelmed when deciding when and how to transact.

Aon has provided lead advice on more than a third of all transactions in the bulk annuities market for the past two years. Using our experience, we have developed Aon's Bulk Annuity Compass for schemes that can demonstrate a commitment to transacting should pricing permit.

Level 1: Monitor

Schemes using Aon's Risk Analyzer can track daily pricing, with feeds directly from the insurance market to give the best available indication of market pricing, before actually approaching the market. This cost-effective approach gives both schemes and insurers certainty regarding readiness to transact.

Level 2: Engage

At this stage, insurers know that the scheme is committed to transacting. Using standardised templates and clear data schedules will help prioritise the scheme further up the queue, supported by bespoke positioning of your individual circumstances – the specific reasons that you are ready to transact and why insurers should commit time and resource to your scheme.

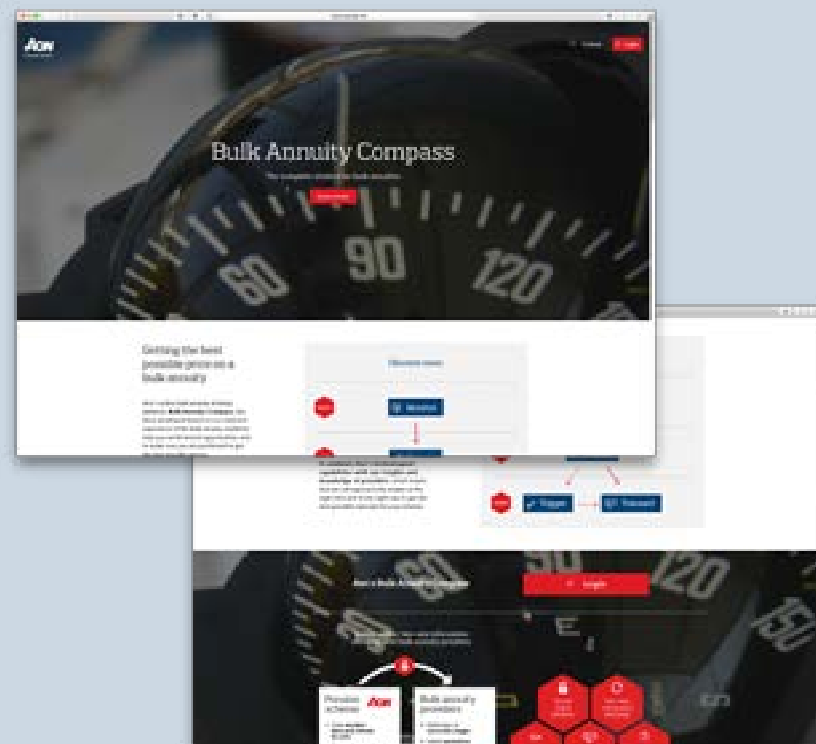
Spending time and focus at this stage will inevitably pay dividends later in the process.

Level 3: Trigger and transact

Even the best prepared schemes might find that, on the specific day that pricing is requested, the stars are no longer aligned and the investment opportunity no longer exists. In the past this often meant the collapse of any potential deal for both schemes and insurers.

Using Bulk Annuity Compass, schemes have the option to hold all information on our platform. You remain ready, committed and focused to transact. As soon as your target price is hit – which may be days, weeks or months – the trigger is pulled and the price can be capitalised on immediately.

Transacting then becomes a focus on certainty: locking in price, utilising comprehensive due diligence and with the option of using preagreed Pathway contracts (negotiated in conjunction with Eversheds). This is a package unique to Aon clients – from which many benefited in 2016.



Click here to access Aon's Bulk Annuity Compass:

http://www.aon.com/unitedkingdom/retirement-investment/pensions-stability/risk-settlement/services/bulk-annuity-compass.jsp

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Martin Couzens, chairman of the Alcatel-Lucent Pension Scheme, talks about de-risking following a third successful risk settlement transaction advised by Aon.

How do you maximise the chance of a successful annuity auction?

Aon's Compass service flagged the opportunity in the summer and we transacted shortly after attaining an attractive price. Critically, the trustees and their advisers operate as one joined-up team that is ready to react quickly to prioritise opportunities.

Although very fast, our transaction was still supported with thorough planning and advice. We have gained familiarity with the market and Aon's deep knowledge allows us to focus quickly on the key issues for each transaction.

What are your objectives?

I see the full securing of benefits as a primary objective of the trustees, and am very happy that we have made great strides in de-risking over recent years.

Risk has been reduced substantially across our asset portfolio and annuities have been added smoothly without disturbing our existing hedging arrangements.

We have now successfully implemented annuities with Aviva, PIC and Rothesay Life, with a positive funding experience from each of these purchases.

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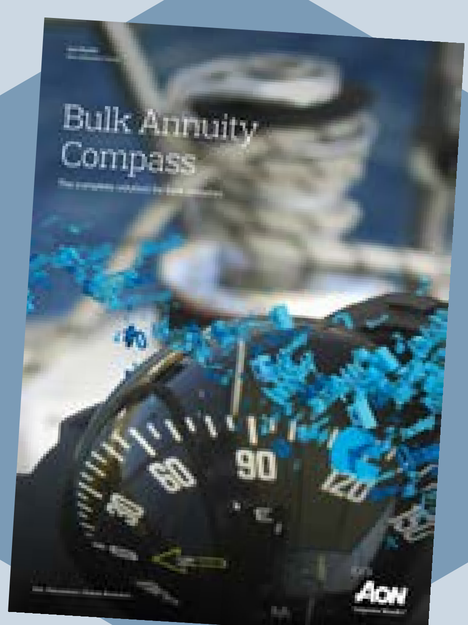

Watch this video for information on the key factors to consider when investing in a bulk annuity.

Key points

- More than two-thirds of bulk annuities purchased in 2016 followed on from prior settlement transactions
- Multiple annuities can be cheaper and easier than a one-off buy-out in the long run
- Don't take our word for it – see how Smith's Group have benefited from a tranched approach

Eight reasons to adopt a tranched buy-in strategy

Increasingly, the annuity market is becoming dominated by schemes securing their liabilities in phases, as it becomes affordable. What are the advantages of the tranche approach, compared with the apparent efficiency of one final annuity to secure everyone?

1.

First annuity gives conviction

It establishes the trustees' comfort with the market, the criteria for deciding to purchase annuities, and also the framework for choosing the insurer and the benefits to secure. It also establishes the scheme's credentials with the market as a serious purchaser.

2.

Optimal market pricing

For many schemes, the full scheme would represent a large transaction which some bidders may struggle to absorb. Competitive pressure is maximised by placing in tranches.

3.

Make the most of annuity provider preferences

As providers' target markets differ, it is possible to choose a tranche that represents the profile preferred by a particular segment of the market. An example is the securing of larger pensions with a provider who likes to price these benefits accurately using medical information.

4.

Restrict financial impact

Avoiding a material adverse impact on funding, corporate accounting, cash or expected returns can be key criteria for de-risking. The acceptable parameters can determine the affordable size of the next transaction.

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5. Synergy with investment strategy

As schemes mature, they will gradually hold more low-risk assets that can easily be exchanged for an annuity without impacting the overall investment objectives of the scheme. These include maintaining the hedging strategy for benefits not secured. The tranche approach can make more efficient use of assets as soon as they can be freed up.

6. Data cleansing

The annuity programme may be tailored to gradually secure different sections of the scheme once the benefit entitlements in them are fully cleansed and finalised.

7. Restrict hedging costs

For some liabilities, the cost of securing them will decline over time to a more digestible amount. This could entail avoiding meeting the cost of hedging some more expensive inflationary pension increase terms until the members are older.

8. Easier decision-making

It is just simpler to make decisions with a smaller impact. One big annuity purchase needs more thinking time and consultation. In the meantime, market opportunities will come and go.

Don't just take our word for it

Watch this video to see how Smith's Group have benefitted from a tranched approach. **Allan Whalley, Group Pensions Director for Smiths Group plc**, highlights the benefits to a corporate sponsor of securing six bulk annuities across two pension arrangements since 2008.

Paul Belok
Partner
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Member options can help prepare benefits for settlement

Key points

- Save up to 10% on your annuity costs by reshaping your benefits
- Offering members the choice can appeal to trustees and sponsors
- Act now to prepare for buy-out – you may be closer than you think

At the simplest level, bulk annuities can offer a better match for liabilities than similar low risk assets and offer a greater investment return. But the complexity of benefits in UK pension schemes can quickly increase that cost, particularly for non-pensioner members.

Understanding which areas of a scheme's benefit structure are most difficult and expensive to insure is an essential first step to getting the best value from the market. Only then can you consider whether and how to simplify your scheme and to improve member security.

Taking three examples:

1. Pension increase exchange

Most pensions that increase in line with inflation have a floor to protect against deflation. Regardless of how unlikely there is to be a sustained period of deflation, the cost of insuring this floor can add up to 5% to the insurance premium.

Offering members the option to exchange pension increases for a higher non-increasing pension (or the same pension with fixed increases) will reduce the bulk annuity cost and avoid the need to pay a deflation premium, even where this is offered on a 'fair value' basis.

2. Transfer value options

The cost of insuring non-pensioners is expensive, as shown by the absence of non-pensioner only transactions. It is with good reason that schemes start the annuitisation process with pensioner members.

By comparison, a typical scheme transfer value for a deferred member is materially lower than the insurance premium – and so is the transfer value offered by an insurer following a transaction. Taking pro-active steps to help members understand the options available – which will result in some members transferring benefits elsewhere – provides choice and avoids schemes paying potentially unneccssary insurance premiums for those individuals in the future.

3. Trivial commutation

The cost of securing and administering members with small benefits can be hugely disproportionate to the size of their benefit. For many members, this pension can form a relatively small proportion of their overall income and a cash lump sum can be attractive and convenient.

Unlike regular trivial commutation, at the time of a full scheme buy-out there are no age restrictions over when members can take this option, making it a further attractive opportunity for some members.

Getting your scheme ready for a potential bulk annuity is now much more than a data cleanse. Material savings can be made by restructuring benefits and offering members an option, but this is a thought process that needs to begin many months before any transaction takes place.

When buying out a £100m pension scheme

- A Pension Increase Exchange can save £1m on the cost of an annuity
- Offering enhanced transfer values can save 20% of the cost of your non-pensioners – that is potentially £8m for some schemes
- Trivially commuting small benefits could reduce insurance costs by £1m
- Flexible Retirement Options allow schemes to buy-out benefits on less expensive pensioner terms.

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Right approach, big benefits: why we launched Bulk Annuity Compass

Key points

– Plan your approach with the support of all stakeholders

– Prepare to go to market with clean data and agreed benefit requirements

– Price monitoring can help you save up to 10% on the cost of your bulk annuity

With funding deficits plaguing many UK pension schemes, the desire to reduce risk exposure continues to be top of the agenda for most trustees and sponsors. However, the best matching hedging instrument, an annuity, is often considered ‘unaffordable’ unless well-funded.

At Aon, we have proved that with the right approach the opportunity to annuitise may be closer than you think. Looking at the most successful bulk annuity transactions, we regularly see three consistent themes:

– Coordinated planning

– Detailed preparation

– Regular price monitoring

Planning

Successful transactions require the support of multiple stakeholders and rapid decision making. It is crucial that all parties understand the implications of the transaction for both the pension scheme and the sponsor. Well run and successful bulk annuity projects have:

– Upfront training for trustees and sponsors

– Delegation of day-to-day decision-making to a small joint working party

– Pre-agreement of a transaction strategy including:

- A reasonable price target that all key stakeholders commit to;
- An assessment of which assets are used to fund an annuity and residual portfolio considerations; and
- Insurer selection criteria to best suit your needs.

Preparation

Engagement with insurers begins with an introductory phone call and provision of a transaction pack containing member data and the scheme’s benefit structure. Providing accurate and comprehensive information means insurers can reduce reserves for uncertainty and deliver better prices. Simple steps that can be taken include:

– Gather up-to-date marital status and spouses’ dates of birth;

– Clean the data ensuring all key items are complete and up-to-date (eg postcodes); and

– Request the scheme’s lawyers, administrators, and scheme actuary review the benefit specification ahead of sharing with an insurer.

Watch PIC's Jay Shah talk about what is important to an annuity provider.

The Pilkington Superannuation Pension Scheme entered into a buy-in with Pension Insurance Corporation covering £230m of its pensioners. **They made significant savings**, thanks to preparation and being at the front of the queue when it mattered most.

Price monitoring

2016 demonstrated the benefit of timing access to markets, with volatile conditions driving pricing opportunities. Our clients saved more than £40m by capitalising on favourable pricing and market conditions. Key to this is:

– Regular monitoring of bulk annuity pricing in relation to your pricing target; and

– Being positioned in the insurance market so you can capitalise on pricing opportunities when they arise.

Preparation, planning and price monitoring saves millions of pounds

How big are the potential savings?

By combining planning, preparation and price monitoring we see our clients saving up to 10% on their bulk annuity transaction prices.

– Planning – efficient investment transfer 0%-1%

– Preparation – starting with clean and complete data 0%-3%

– Price monitoring – optimal transaction timing 0%-10%

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Longevity Hedging

The UK longevity swap market in 2016

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Structuring large longevity deals

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Mid–market longevity hedging: the door is open

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Our checklist for purchasing longevity insurance

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The UK longevity swap market in 2016

Key points

- **A quieter year for pension scheme risk transfer with less than £3bn of deals in 2016**
- **Find out why a number of pension schemes chose to defer the purchase of longevity insurance**
- **2016 saw the smallest deal to date, covering £50m of liabilities**

A quiet year for longevity risk transfers

After a slow start to the year, three pension scheme transactions were completed in the second half of 2016, including the Pirelli transaction for £600m (covering two pension schemes) and the smallest UK transaction to date covering £50m of liabilities with Zurich and Pacific Life. Even with activity picking up in the second half of the year, it still proved to be one of the quietest years to date for pension scheme deals overall, with less than £3bn of liability transferred to providers.

UK defined benefit pension scheme transactions announced over the course of 2016:

Date	Pension Scheme	Size of transaction	Structure	Provider
December 2016	Undisclosed	£900m	Undisclosed	Legal & General
October 2016	Undisclosed	£50m	Fully intermediated	Zurich / Pacific Life
August 2016	Pirelli	£600m	Fully intermediated	Zurich / Pacific Life
August 2016	Manweb (Scottish Power)	£1bn	Fully intermediated	Abbey Life

But why was it quiet?

The introduction of Solvency II at the start of this year generated an increased appetite from UK insurers to transfer risk to the reinsurance market, meaning the availability of resources to price longevity risk transfer for pension schemes has been increasingly stretched throughout the year.

2016 has brought some challenging market conditions, in particular low gilt yields following the outcome of the EU referendum, leading to an increased cost of capital for reinsurers and a corresponding requirement for higher reinsurance premiums to transfer longevity risk.

Crucially, over the course of 2016, it became increasingly apparent that emerging deaths data suggested lower future improvements in mortality. In isolation, this would be expected to improve reinsurer pricing. However, as you might expect, reinsurers were naturally cautious and took time to digest and reflect this in their pricing. As indicated in our press releases in October 2016 and February 2017, we viewed pricing to be 'dislocated' in this regard.
A consequence of this was that a number of pensions schemes chose to defer purchase of longevity insurance until pricing more fully reflected the observable trend.

Market capacity for new business

Challenges on pricing aside, capacity remains strong with more than 10 reinsurers actively pricing on transactions over the course of 2016, each with over £500m of capacity and in some cases appetite for multi-billion pound transactions.

Intermediation options

The intermediation market is continuing to evolve, offering a variety of structural options to pension schemes, particularly at the larger end of the market. There are now fewer market participants in the traditional fully intermediated space, with Abbey Life and Deutsche Bank withdrawing, following the sale of Abbey Life to Phoenix in September 2016. However, the alternative contract structures offered to pension schemes looking to transfer longevity risk at the larger end of the market remain competitive and present a number of options.

The decision regarding which provider to approach and by what structure requires careful consideration, especially when weighing up the costs and risks of all available choices.

UK insurer longevity risk transfer: an efficient strategy

Under the Solvency II regulatory regime, it has become increasingly capital efficient for insurers to transfer longevity risk to reinsurers. This has been shown by increased activity from UK insurers to line up reinsurance for both back-book and new bulk annuity transactions. Over the course of 2016, Aon continued to help UK insurers transfer longevity risk, maintaining our position as lead adviser on longevity risk transfer for both pension schemes and insurers.

During the course of 2016, a number of significant deals were disclosed by Legal & General and Pension Insurance Corporation. In addition, there are a number of further multi-billion reinsurance placements not publicly disclosed.

Encouraging signs for 2017?

Overall, it is clear that there is scope for growth in 2017 based on UK pension scheme and insurer demand and capacity for risk transfer. The extent of the growth in the pension scheme risk transfer space is likely to depend on the speed and extent to which reinsurers are able to more fully reflect the observable trend in mortality improvements in their pricing. The good news is that we have already seen significant movement in improvement assumptions from reinsurers on ongoing transactions. This is an encouraging sign for pension schemes looking to transfer longevity risk in 2017.

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Mid-market longevity hedging – the door is open

Key points

- Reinsurers are now actively pricing for sub-£500m transactions
- Appetite from pension schemes for longevity-only solutions is driving innovation
- Efficient and cost effective solutions for hedging longevity risk for pensioner liabilities under £500m

With the second sub-£100m pension scheme longevity swap transaction completed with Zurich and Pacific Life, it is clear the longevity hedging market is now firmly open for pension schemes of varying size. Historically, the longevity hedging market has remained focused on £500m+ pension schemes, where reinsurers, who have capacity and appetite for longevity risk, have been keen to concentrate their capacity and resources. So, what has changed?

Demand for longevity-only solutions

Many UK defined benefit pension schemes are working towards a long-term target of buy-out or self-sufficiency. For some schemes, some form of annuitisation may not be immediately viable (for example, if low risk assets are tied up in a leveraged LDI portfolio and the investment strategy needs time to deliver anticipated returns). For other schemes there may be appetite to adopt a 'do-it-yourself' approach to cashflow matching and retain investment flexibility. But what is clear across the board is that there is strong demand to reduce the level of exposure to longevity risk, either as part of a tactical risk management strategy or as an early stepping stone towards ultimate buy-out. This means that we are increasingly seeing appetite for cost-efficient solutions for the smaller and medium schemes, which in turn is helping to drive innovation in the marketplace.

Active market, growing appetite

Unlike the larger end of the market, where typically more than 10 reinsurers have capacity and appetite to take on longevity risk, the sub-£500m market is currently supported by four reinsurers who are set up to price solely based on socio-economic factors such as postcode and pension size, as a proxy for wealth, lifestyle and health. This is different from the larger end of the market, where a large volume of credible experience data is available to support and/or inform pricing. The establishment of this market, with providers actively pricing, is good news and demonstrates reinsurer appetite and anticipation of a greater flow of business expected in relation to sub-£500m transactions.

A simple and cost-effective approach

With appetite from pension schemes to transfer risk and capacity from reinsurers to enable risk transfer to take place, we are seeing increased innovation. This has involved removing some of the complexity that we have seen to date on multi-billion transactions with a view to simplifying day-to-day management of deals and reduce operational costs. This includes adopting:

- An uncollateralised approach – with the pension scheme relying on regulatory protections (and ultimately the Financial Services Compensation Scheme) in relation to default of the longevity risk provider.
- Simplified and standardised terms – as well as the removal of collateral requirements, simplified terms in relation to data, benefits and ongoing management mean that a swap need not be administratively onerous for a pension scheme. Further, use of standardised terms offers a governance-light and cost-effective approach to implementation.

All of the above has contributed to making the purchase of longevity insurance viable for pension schemes looking to hedge sub-£500m of pensioner liabilities. Please get in touch to find out how Aon can help you to purchase longevity insurance cover for your pension scheme.

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Key points

- **Significant cost savings can be achieved by adopting more complex structures**
- **Will there be a move towards increased standardisation of terms?**
- **Will innovation at the smaller end of the market feed through to big deals?**

Structuring deals for schemes at the larger end of the longevity market

Intermediation, innovation and your future options

There are now a number of structural options available to trustees and sponsors seeking to purchase longevity insurance, particularly at the larger end of the market where it is possible to access economies of scale. Choosing between the different options requires careful consideration of the costs and risks involved.

Intermediaries: exploring the alternatives

It is not legally possible for pension schemes to contract directly with the global reinsurance market where there is appetite to take on longevity risk to offset mortality risks relating to life insurance and catastrophe business. Therefore, an intermediary is required to 'sit in the middle' and facilitate the transaction. The intermediary can take on the ongoing management of the swap as well as wider structural risks such as reinsurer credit risk, regulatory risk and legal risk. However, the intermediary will charge a fee for arranging this. For a number of years, pension schemes have been exploring alternative structures to access the reinsurance capacity in a more direct way with the aim of achieving cost savings in relation to intermediation fees. The typical longevity swap structure is summarised in the diagram below:

Your intermediation options

In summary, there are three key intermediation options:

- **Fully intermediated** – the 'one stop shop', where the pension scheme transacts with a single counterparty, typically a UK insurer. This intermediary takes on the ongoing management and structural risk, but will charge a fee for arranging all of this.
- **Pass through** – if the intermediary is a UK insurer, this is the same as a fully intermediated approach where the pension scheme contracts directly with the insurer. However, under this approach the pension scheme also takes on the credit risk of the reinsurer(s) and in return pays a lower intermediation fee. The pension scheme would need to analyse and be comfortable with taking on the reinsurer(s)' credit risk under this structure.
- **Self intermediated** – here the pension scheme sets up its own intermediation vehicle and is responsible for the ongoing management as well as taking on the structural risk. This would typically involve establishing and managing an offshore vehicle which could simultaneously provide insurance to the pension scheme and purchase corresponding reinsurance protection. For schemes which are comfortable with the ongoing management and associated risks of this type of arrangement, this structure can offer significant savings.

Watch Hannah talk about the different longevity structures available in the market.

What does this mean for future transactions?

For the majority of pension schemes, the fully intermediated or pass through approaches will be the most appropriate structure given the onerous administration and structural risks associated with the setting up a pension scheme owned insurance vehicle (ie 'self intermediated').

As providers and reinsurers become increasing comfortable with the pass through structure, we anticipate a move to a more standardised approach to contracts, with schemes focusing more on scheme-specific commercial terms.

Will small scheme innovation influence larger scheme deals?

We noted earlier in the brochure (page 23) that demand for longevity protection is driving innovation for sub-£500m transactions – typically through the adoption of a simplified approach to both the day-to-day management of the swap as well as foregoing the use of collateral.

The simplification of ongoing management has been a necessity at the smaller end of the market, where per member costs would be disproportionately high without a more simplified approach on ongoing administration. At the larger end of the market, economies of scale mean that transactions have been viable without considering wider administrative simplifications. Having said this, if savings can be achieved without introducing significant credit (or wider) risk exposures for the various parties there could be merit in exploring a more simplified approach. This is something we expect the market to explore to a greater extent over the course of 2017 and beyond.

Collateral: A simpler future?

In terms of adopting an uncollateralised approach on larger transactions, this is likely to depend on the type of structure. Overall, on larger transactions, we expect that for the majority of transactions a collateralised approach will continue to be adopted given the credit risk exposure that can arise on £multibillion transactions. However, we expect that both providers and pension schemes would welcome a simpler approach on some collateral aspects, whilst continuing to ensure appropriate mitigation of credit risk.

So, watch this space!

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Meet the team

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Our checklist for purchasing longevity insurance

Key points

- Over 50% of pension schemes do not hold comprehensive data needed for insurance transactions
- Our top tips to ensure success on a longevity swap transaction
- Establish a decision making framework and determine the structure at outset

We see time and time again that the best prepared schemes are the ones able to secure the best outcomes on transactions. Here are our top tips for trustees and sponsors looking to purchase longevity insurance:

☑ Be clear about data and benefits

Seeking clarity over data and benefits before approaching the market helps to ensure a fair price is paid for the risk transferred and ensures that you are not paying unnecessary premiums or signing up to onerous contract provisions in relation to 'unknown' data risk. For many schemes, this is likely to involve upfront collection of marital data (eg marital status, spouse date of birth and spouse gender) and accurate calculation of contingent spouse pension amounts.

In addition, this clarity helps to minimise the risk that the benefits being insured differ from the benefits that need to be paid by the pension scheme. This risk is commonly referred to as 'basis risk'.

☑ Know your risk profile to benchmark best prices

Having an up-to-date assessment of your longevity risk and best estimate mortality assumptions helps to set a robust benchmark for assessing quotations. This will ensure that you are securing the best possible pricing, based on all information available at that time, and can also form a basis for a robust dialogue with providers in relation to any price requirements. The Aon Hewitt Longevity Model can provide you with this information and has underpinned all of the longevity transactions we have advised on to date.

The Aon Hewitt Longevity Model is used by almost 900 clients, and has been pivotal in setting mortality assumptions for around £1trillion of liabilities.

☑ Establish your decision making framework

We see the best results when key stakeholder requirements are considered upfront, with a decision making framework established at outset. For the majority of transactions we have advised on, this has involved the establishment of a joint working group, with both trustee and company representatives, who are focused on delivering the transaction. This enables quick and effective decision making, and helps to ensure provider engagement throughout, improving the chances of achieving the best outcome on a transaction.

☑ Find the right structure

There are a number of insurance options available for pension schemes looking to transfer longevity risk, including bulk annuities (with the added benefit of wider risk transfer) and a range of longevity swap solutions.

For schemes that have available low risk assets (eg gilts), a bulk annuity can be an effective way of increasing your overall portfolio return, at the same time as securing longevity protection.

There are now a number of longevity swap structural options available in the market, with significant cost saving available for some of the most complex structures. Therefore, it is important trustees and sponsors looking to purchase a longevity swap consider the benefits and risks of all of these options to identify the most appropriate structure for their scheme. It is also important to have structural clarity when engaging with reinsurers, enabling them to provide quotations in the context of any structural risks they will be taking on as part of the transaction.

Having clarity on the vehicle (be it a bulk annuity or a longevity swap) and structure upfront, will also help to ensure maximum reinsurer and/or insurer engagement, better pricing and an efficient broking process.

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Longevity Trends

What a difference a year makes

Read more

Slowdown in life expectancy improvement rates: should we keep purchasing longevity insurance?

Read more

Longevity trends – what a difference a year makes

Key points

- **Evidence indicates that we have entered a phase of low mortality improvements**
- **To what degree should longevity insurers and reinsurers recognise the change in longevity trend?**
- **Be careful you don't overpay for longevity insurance**

- **30,000 more deaths than expected in England & Wales in 2015, and 25,000 more than expected in 2016**
- **National male mortality improvement since 2011 has been under 1% per year compared with over 3% per year for the previous decade**

What do mortality trends tell us?

Mortality in 2015 was unexpectedly heavy – there were around 30,000 more deaths than expected in England & Wales (in the context of total expected annual deaths of around 500,000). The consensus market view in early 2016 was that 2015 was probably a 'blip', with the excess mortality widely attributed to the ineffectiveness of the 'flu vaccine in early 2015. However, there was an opposing view, ie that the underlying drivers and other external indicators were already suggesting that a downturn in longevity improvements was already upon us.

The actual response of the longevity industry would hinge on the data emerging in 2016.

- If the deaths in 2016 matched the pre-2015 predictions then 2015 would likely be chalked up by many as an outlier.
- But if 2016 were also a heavy year, then it would no longer be credible to ignore the change in trend that has been emerging since 2011.

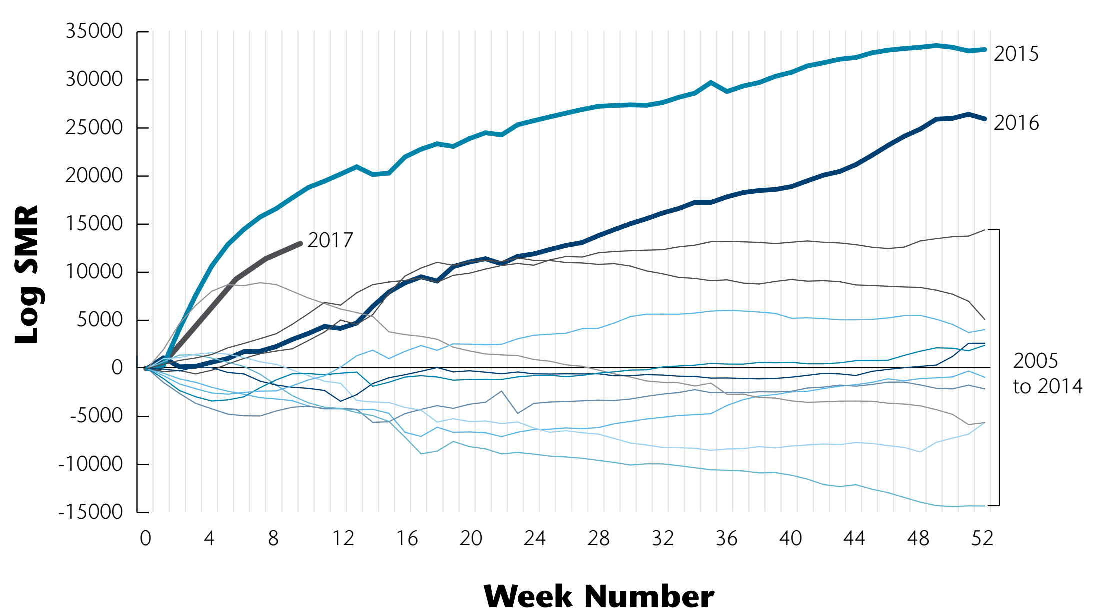
2016: Another heavy year

You can get a feel for how things have developed from Chart A, which shows cumulative total deaths in England & Wales from the start of each calendar year less the average of the same figure over the decade 2005 to 2014. The population is growing larger and older, both of which tend to result in more deaths but this is – very broadly – offset by expected improvements. In other words, in some approximate sense, we are expecting the lines on the chart to be in a band around zero. The chart shows the following features:

- The initially very heavy mortality in 2015 (ie the steep rise in deaths up to week 8) – this was widely attributed to the ineffectiveness of the 'flu vaccine that winter.
- The total high deaths for 2015 end at over 30,000 more deaths for the year compared with the average over the previous decade.
- 2016 was initially a moderately heavy year, appearing to track 2013 closely. But as it progressed, it also has turned into a very heavy year, ending with over 25,000 more deaths than the average in the decade to 2014.

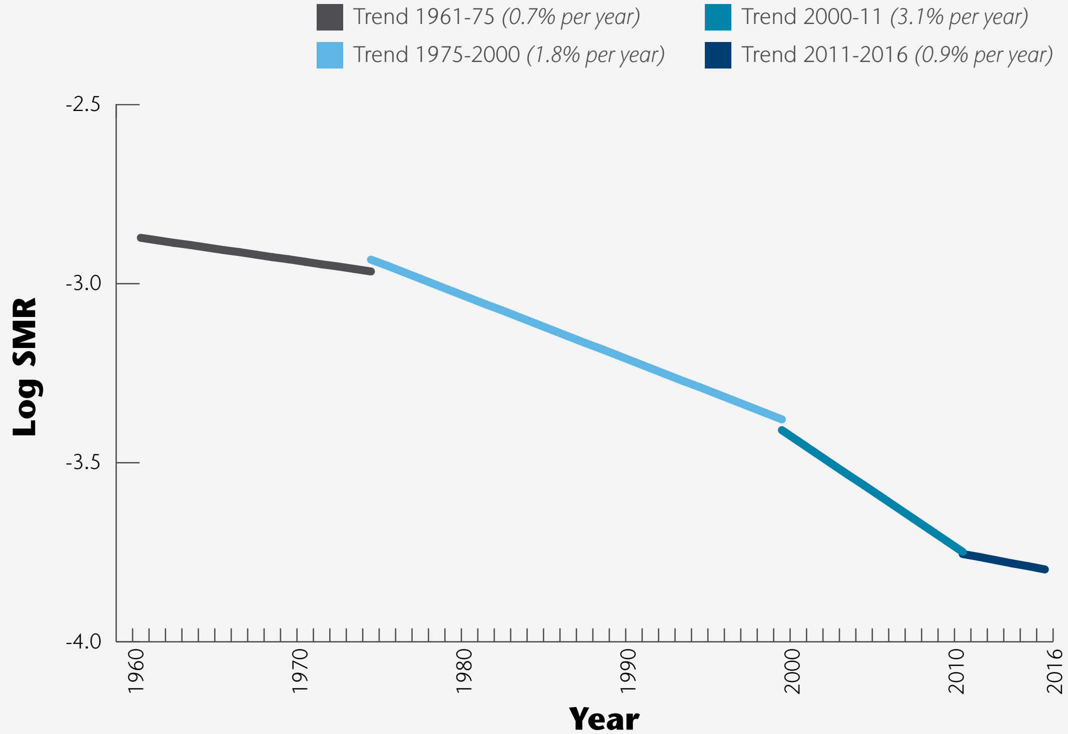
We now have the data for 2017…and it supports the view that the underlying improvement trend is lower.

Cumulative deaths in England and Wales by week compared with average over 2005 to 2014



Source: Aon Hewitt calculations using data from the Office for National Statistics. The standardised mortality rate (SMR) is based on the subset of the European Standard Population. 2013 for males aged 50 to 89 last birthday inclusive.

Log standardised mortality rates E&W male



Source: Aon Hewitt calculations using data from the Office for National Statistics

Taking the long view

To place this in context, we need to review the pattern of longevity improvement over a longer period than a decade. Accordingly, in Chart B below we have plotted standardised male mortality rates by calendar year over the period since 1961, together with some trend lines[1]. The chart shows:

– the relatively high longevity improvements over the final quarter of the last century (Trend 1975–2000),

– the very high longevity improvements experienced over the first decade of this century (Trend 2000–11), and

– the dramatically lower improvement trend that has emerged since 2011 (Trend 2011–2016), and which is not dissimilar to historical longevity improvements before 1975 (Trend 1961–75).

No such thing as a 'sure thing' – so plan carefully

There is no 'sure thing' in mortality prediction – it is still perfectly possible that future longevity improvements could revert to their previous high rates. However, it does now seem that the weight of evidence (in terms of observed national mortality rates[2]) is swinging towards the view that we are in a lower improvement trend regime. What is important is that if you are contemplating a longevity protection transaction, you ensure that the pricing you receive is bang up-to-date. There is now statistically credible evidence that we have entered a low mortality improvement phase.

The key question for the longevity market is **"to what degree should longevity insurers and reinsurers recognise the change in trend?"**. For longevity swaps in particular, but also bulk annuities, trustees and plan sponsors need to be careful that they don't overpay for longevity risk protection.

Tim Gordon
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1 The standard Office for National Statistics data starts in 1961. This is also a reasonable starting point to review mortality improvement trends in the modern (ie post Second World War) period.

2 When forming a considered overall view for future longevity improvements, observed national mortality rates are not the only item of information. We would expect to factor in (a) the pattern of improvements by cause of death, (b) estimation of how the drivers of future longevity improvement are likely to play out and (c) whether the population under consideration (ie pension plan members with liabilities weighted towards those with larger pensions) might have a different outlook from the national population as a whole.

Slowdown in life expectancy improvement rates: should we keep purchasing longevity insurance?

Key points

- **Longevity insurance, through a swap or annuity, is a fundamental risk management tool**
- **What is your appetite to withstand downside risk?**
- **Conduct an accurate assessment of longevity risk to ensure you pay the right price for insurance**

There has recently been a reduction in the expectation of future improvements in life expectancy based on the observable change in trend coming through in relation to emerging deaths data. If life expectancy is not increasing at the rate previously expected, should pension schemes still continue to purchase longevity insurance?

The straightforward answer to this question is yes, hedging longevity risk remains attractive for many pension schemes, if:

1. the pension scheme does not have the appetite to retain exposure to longevity risk; and
2. the insurance cover is priced fairly (ie current trend expectations are reflected, and risk premium is proportionate to the risk quantum)

Appetite to transfer risk

As with the purchase of any insurance, it is important to consider the cost of insurance relative to any downside risk. This will help inform your appetite to self insure or transfer the risk.

Longevity downside risk is commonly assessed by considering a potential increase or 'shock' in liabilities that could arise from an adverse movement in longevity trends, and can be more significant than you think. Typically, there is a 5% chance that pension scheme liabilities can increase by between 15-20% over the lifetime of your liabilities because members are living longer than expected. Lower yields have pushed up the risk, by amplifying the liability impact of higher life expectancy. Therefore, trustees and sponsors of defined benefit schemes need to consider their appetite to withstand this risk relative to the premium to remove this risk.

Finding the right protection

If there is appetite to seek insurance, then the most appropriate means of doing so needs to be considered based on scheme specific circumstances. It might be that your scheme is in a position to secure wider risk transfer, including longevity risk protection, via a bulk annuity. This is likely to be particularly favourable if there is an opportunity to maintain – or even increase – your overall portfolio return by transferring a low risk portfolio of bonds to an insurer. If annuity purchase is not achievable in the short term, eg due to investment strategy constraints, or there is a preference to retain investment control and flexibility, then it makes sense to consider the merits of a longevity swap to secure longevity protection.

Typically, there is a 5% chance that pension scheme liabilities can increase by between 15–20% over the lifetime of your liabilities because members are living longer than expected.

For pension schemes that are seeking stability, both in terms of cash funding certainty and reduced balance sheet volatility, purchasing longevity protection can remain extremely attractive.

Martin and Tim explain the recent longevity trends and the current dislocation with reinsurance pricing

Paying the right price

It is impossible to predict with complete accuracy what the future holds in terms of longevity trends – this is a key reason why longevity risk is material for all unhedged schemes. In the first decade of this century, longevity improved at an unprecedented rate. But not only was the rate of improvement high, it was also very consistent – mortality reduced very steadily year-on-year. The continued improvements in life expectancy are what caused many pension schemes to begin to hedge exposure to longevity risk and underpinned a very active longevity market over the period 2010-2015. While the recent tailing off in very high improvement rates might lead many schemes to pause for thought, this does not mean that the situation might not revert.

For those pension schemes that are seeking stability, both in terms of cash funding certainty and less balance sheet volatility, purchasing longevity protection can remain extremely attractive – whether this is through a longevity swap or bulk annuity. However, it is crucial to ensure that a fair insurance premium is being paid for the risk that is being removed. Leverage the latest data to avoid overpaying.

When purchasing a longevity swap, or a bulk annuity, if up-to-date expectations of future longevity are not taken into account in pricing, schemes could be in danger of overpaying for the protection. This is something we observed in 2016, when emerging data suggested a change in trend towards lower future improvements. At this time, reinsurers and insurers were naturally cautious about reducing their pricing to take account of this observable change in trend. We highlighted this price dislocation in our press release in October 2016. Since then, we have started to see significant price improvements from reinsurers, although inevitably this varies considerably on a case-by-case basis as the market gradually adjusts to the latest data.

All of this serves to emphasise the importance of having an accurate and up-to-date assessment of longevity expectations for your scheme. This can ensure that a fair price is paid and that pension schemes can be confident in decisions made to execute de-risking deals.

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Global Pension Risk Transfer

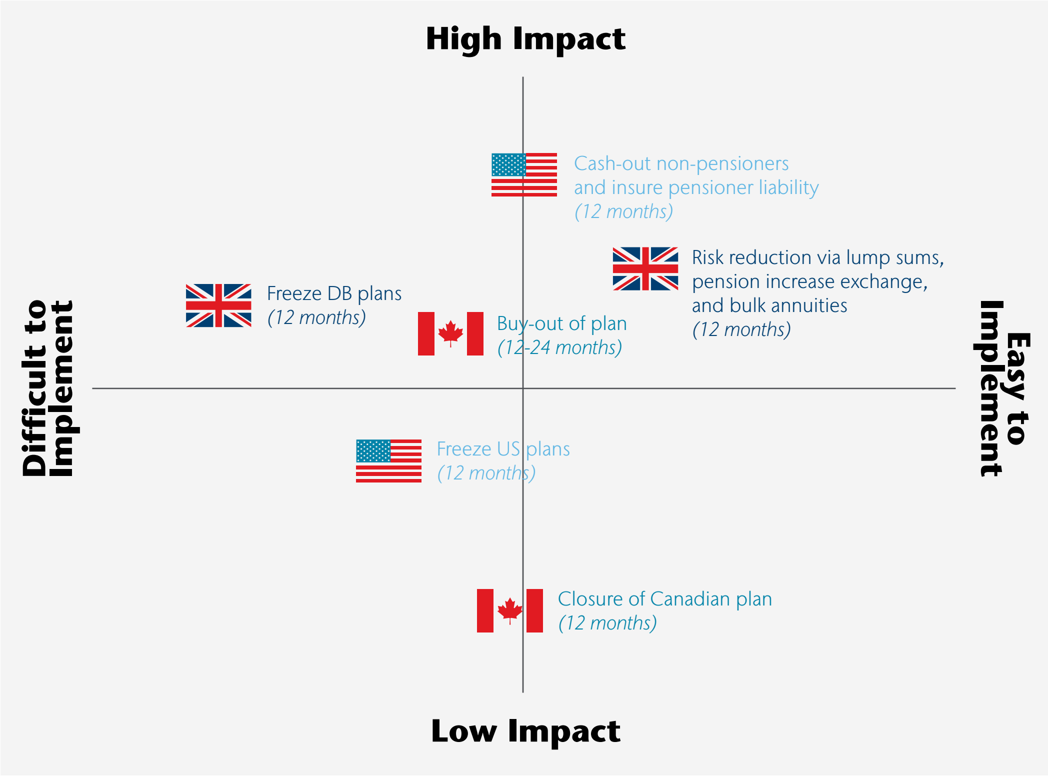
Global growth: risk transfer activity accelerates in 2016

Global trends

Innovation in the market has delivered a wide range of liability management and insurance techniques across countries, which is good news for pension risk reduction. However, the mix of opportunities means it is more important than ever for all parties to understand the full range of techniques available to ensure the optimal global de-risking strategies are adopted. We are now seeing an increased trend for multinational corporations to focus on prioritising their global risk reduction expense, both in terms of cash contributions and management time.

Consider, for example, the opportunity for members to cash-out or transfer-out their pension. This facility exists in many countries but the timing of making the offer is crucial to the outcome. In the US, lump sum windows have been offered for many years, but in 2015 the IRS stopped sponsors offering this option to pensioners, demonstrating the importance of prioritising de-risking actions.

Prioritisation of key opportunities across all countries (example)



The global pension risk transfer market continued to grow in 2016 with increased:

- Corporate and trustee desire for risk reduction;
- Transaction appetite from insurers and reinsurers; and
- Numbers of risk transfer solutions available.

US

2016 was another big year for the US pension risk transfer market with a focus on two main strategies – (a) buy-outs and (b) annuity lift-outs using group annuity contracts and lump sums.

– Largest number of US group annuity transactions ever

– Largest overall liability transfer since 2012

Group annuities

In recent years the US group annuity market has become focused on ‘small annuity’ transactions where companies are looking to lift-out the retirees with the lowest pensions. United Technologies, for example, insured 36,000 retirees whose benefits were $300 per month or less. This strategy is successful, and will continue in 2017 and beyond, as it delivers the greatest reduction in plan costs as both administration costs and Pension Benefit Guaranty Corporation premiums (similar to the UK PPF levy) are calculated on a per member basis and an unfunded liability basis.

Larger transactions also remain common in the US market with WestRock and PPG insuring $2.5bn and $1.6bn of pensioner liabilities respectively in 2016, with Aon providing insurer due diligence advice to the Independent Fiduciaries.

Lump sums

Lump sum payments continue to be a popular pension risk transfer mechanism in the US with typical take-up rates of 58%.

From 1 January 2018, the IRS is expected to update the mortality assumptions underlying these payments. This, together with the interest rate increase in late 2016, means the economics of these transfers are currently looking particularly attractive with many companies expected to prioritise second lump sum windows in 2017.

Canada

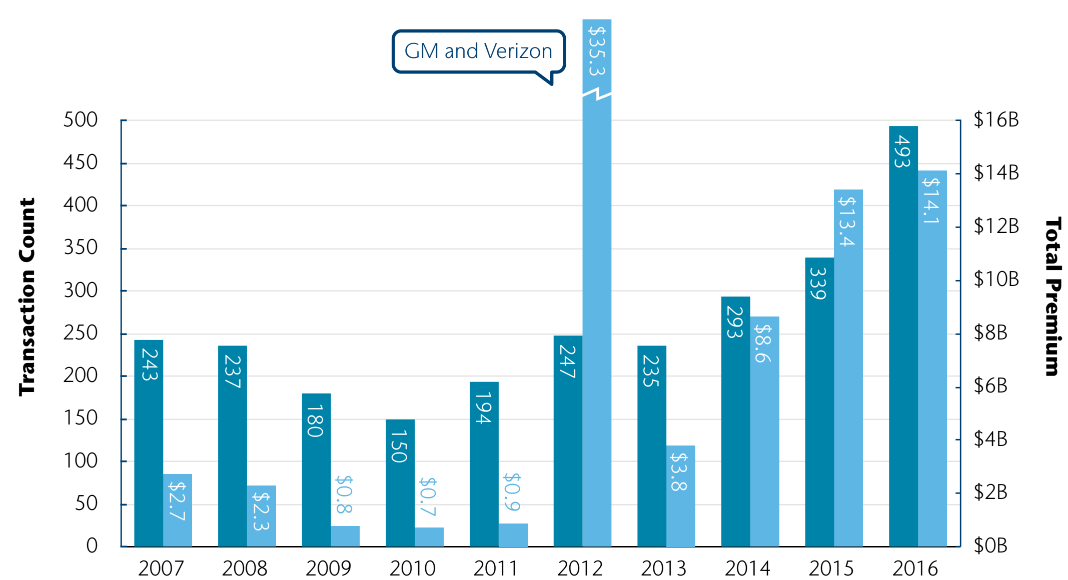
The Canadian settlement market also grew and innovated in 2016:

– Largest ever year for group annuity transactions - $2.7bn

– First small schemes longevity swap for $35m building on first longevity swap in 2015

The Canadian market is still perhaps surprisingly small relative to the US and the UK, despite Canadian DB pension plans holding in excess of $1tn of liabilities. Over time we expect a significant increase in Canadian transactions as momentum builds from both the pension plan demand side and the insurer supply side.

US bulk annuity volumes



Source: Year-end 2016 as reported in insurer responses to Aon Hewitt Investment Consulting’s survey of the most significant U.S. insurers.

Europe

Insurance and reinsurance of pension risk in Europe is currently largely confined to five territories – France, Ireland, Liechtenstein, the Netherlands and the UK. However we are seeing increasing risk reduction interest from pension plans in other countries including Portugal and Italy. Establishing any new market heavily relies on insurer (and reinsurer) appetite to take on the risk. Key factors for insurers include:

- Demand – potential to write a significant volume of transactions
- Assets – availability of pension scheme funds to finance a transaction
- Data – provision of sufficient credible data to allow insurers to price the risks
- Risk – drivers for the removal of risk via insurance

The risk factor is crucial when evaluating insurance costs. The longevity swap market has grown rapidly in the UK in the last 5-10 years due, in part, to pension schemes gaining a better understanding of the size of their longevity risk and comparing this to longevity insurance premiums. This greater insight was aided significantly by the development of a new model of UK mortality improvement. We are now seeing similar models being developed and used by actuaries in other European countries, as well as consulting using the UK's modelling framework in areas where such models do not currently exist.

The majority of the above key supply and demand factors now exist in several European countries and we expect to see the establishment of new longevity insurance markets over the next few years.

Outlook

Global pension risk transfer looks set to continue its path of substantial growth in 2017 and beyond. We expect to see continued innovation in this market with a greater variety of solutions becoming available, including smaller streamlined longevity swaps, and insurance options being offered in more countries, particularly across Europe. Detailed global market knowledge, careful transaction timing and diligent preparation will continue to be the keys to obtaining the best pension risk transfer outcomes.

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Meet the team

Backgrounds in **consultancy**, **investment** and **insurance**

About Aon

Aon plc (NYSE:AON) is a leading global provider of risk management, insurance brokerage and reinsurance brokerage, and human resources solutions and outsourcing services. Through its more than 72,000 colleagues worldwide, Aon unites to empower results for clients in over 120 countries via innovative risk and people solutions. For further information on our capabilities and to learn how we empower results for clients, please visit: http://aon.mediaroom.com/

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