UK Risk Settlement Bulletin

Q4 2019

Market Update – further records

At the beginning of 2019, Aon predicted that this would be another record-breaking year for the UK bulk annuity market.

In our August bulletin, we reported that nearly £18bn of bulk annuity transactions had already been placed by 30 June 2019, which surpassed expectations across the market.

Business since half year

This high volume of business has continued into the second half of 2019, with several multi-billion deals leading the way. This has included the largest ever buy-out, £4.7bn for *telent,* a £2.8bn pensioner buy-in for *National Grid* and a £3.8bn buy-out completed in October for *Asda*. Each of these deals were advised by Aon, and it is notable that each was written by Rothesay Life, who have already completed £16.5bn of bulk annuity business in 2019.

Based on publicised deals and Aon's own transactions, we believe that 2019 bulk annuity volumes have already reached approximately £35bn by the end of October. We expect this to comfortably exceed £40bn by year end.

FTSE 100 companies

With the UK bulk annuity market business volumes capturing the headlines, the sponsors of schemes involved in the transactions are sometimes overlooked.

Thirty-one FTSE 100 companies have now taken steps to remove longevity risk from their pension schemes, with £70bn of completed transactions to date amongst these large firms. And several of these deals have been written in 2019 (e.g. *National Grid* and *HSBC*). This shows that the growth in the risk settlement market is largely driven by the UK's larger companies, associated with bigger schemes.

It is important to understand that there are significant opportunities still available for smaller schemes. Approximately 30% of Aon-advised transactions in the past 18 months have been £30m or under. Although these transactions don't typically hit the headlines, the market is by no means off limits to smaller businesses and schemes who want to protect member benefits. Risk settlement transactions can often be even more important for smaller schemes where ongoing operational expenses can be disproportionate to the cost of insuring.

Bulk annuity business written with UK pension schemes

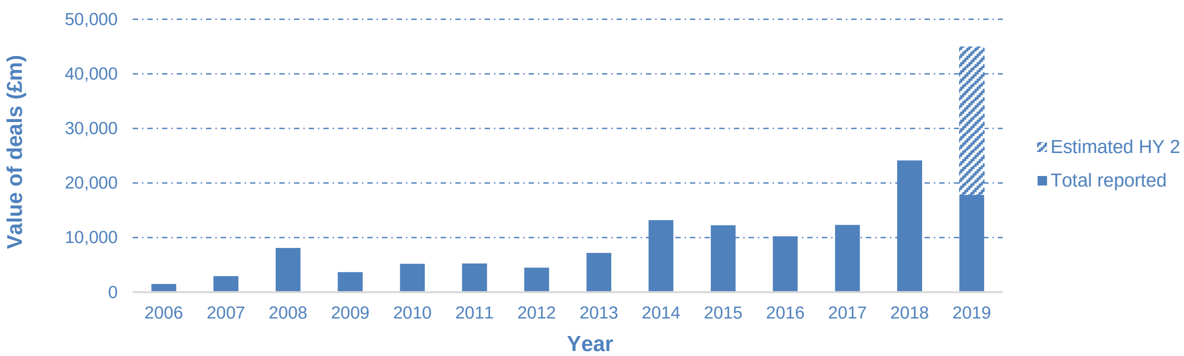


Chart source: Aon's Due Diligence team

Being 'transaction ready'

Schemes looking to complete a transaction in 2020 should be starting to consider the feasibility of a project and beginning to plan the initial steps.

There are a lot of things to think about when considering the feasibility of a risk settlement transaction. How would a transaction affect the scheme's funding and corporate accounting positions? Does such a project have both trustee and sponsor support? What would be the implications for the scheme's investment strategy?

It is important to think early on about the feasibility of a potential risk settlement transaction, so schemes can address any potential issues and maximise the chance of a positive outcome.

Discuss with the employer

Removing longevity risk from your scheme can be very beneficial to the sponsoring employer. It has the potential to reduce future costs such as deficit reduction contributions.

However, the implications of a transaction need to be understood early and fully considered before embarking on a project. For example, a bulk annuity will typically worsen a scheme's corporate accounting position. Furthermore, it may cause a strain against the scheme's funding basis. Is the sponsor aware of these consequences?

Transaction scope

If a partial (rather than full-scheme) transaction is being considered, then the group of members to be insured will have to be chosen. There are various options here, each with different implications for risk reduction, and with future funding and investment implications.

Selecting a tranche of members for insurers can have significant implications for future risk settlement transactions and should be carefully considered. We featured an article on Aon's segmentation model in our June edition explaining in more detail how to select members for a transaction. Since that article, this model has been used to plan in detail the strategy for several large auctions.

Investment impact

A risk settlement transaction will inevitably affect a scheme's investment strategy, in particular the liquidity and leverage of remaining assets. For an annuity, which assets will be sold or transferred to fund the premium? How will residual assets be used to fund uninsured benefits? For a longevity swap, what assets can be used to post collateral? How will collateral calls affect the wider strategy?

Remaining assets will need to be sufficient to meet future cashflows and achieve the targeted expected return. A risk settlement transaction may lower the expected return on assets, and that would be expected to lengthen any recovery plan and increase reliance on the sponsoring employer. But a scheme would run lower risk over this longer period.

Benefit clarity

Insurers participating in an auction like clarity. Ambiguity of data or benefits requires more work from them and may harm engagement. Missing data could lead them to increase prudence in their pricing assumptions, worsening pricing.

The most common types of gaps in data relate to marital information, mortality experience, and contingent spouse pensions. Improving these is sometimes a 'quick win', relatively simple and hugely beneficial for price.

Ahead of transaction, we recommend schemes seek a legal review of their benefit structure to identify any inconsistencies. This reduces the risk of making affordability decisions based on limited information.

In a crowded market place, having this clarity will help schemes stand out. There is increased likelihood of execution, something insurers are keen to see.

Project governance

There will be several significant and sometimes complicated decisions to make in the risk settlement process.

Schemes sometimes delegate authority to a joint working group, with both trustee and sponsor representation. Agreeing clear responsibilities, objectives and decision-making criteria will help the project to run smoothly.

Diversity of thoughts can be beneficial, and representing views from all parties will help to ensure consistency of direction between stakeholders. This will help to minimise conflicts and ultimately drive better outcomes. It is important to consider any behavioural bias that may affect decision making in a risk settlement project. See our September bulletin for further details.

Please get in touch with your risk settlement contact if you would like any further information or would like to discuss in detail what a full feasibility exercise would include.

An example dashboard extract for transaction readiness

Item	Preparation	Actions
Impact on financial metrics	Has the scheme considered the impact of a transaction on funding, expected return, accounting, etc?	Explore as part of a feasibility study
Setting up a sub-committee	How will the Trustees and Company work together? Would a sub-committee have any delegated powers?	To be established
Benefit specification	Does the scheme have a benefit specification readily available to share with insurers? Has it been reviewed by legal advisers?	The valuation benefit specification could be used as a starting point
Member tracing	Does the scheme carry out regular member tracing of addresses and member existence?	Yes
GMP Reconciliation	Has a GMP reconciliation exercise been carried out, with the results reflected in administration records?	In progress, not yet complete
Investment strategy	Does the investment strategy allow for de-risking over time in line with the scheme's long-term objectives?	Yes, scheme has a plan for de-risking

Chart source: Sample extract from an Aon risk settlement feasibility study summarising headline topics

Insurer bulk annuity cost

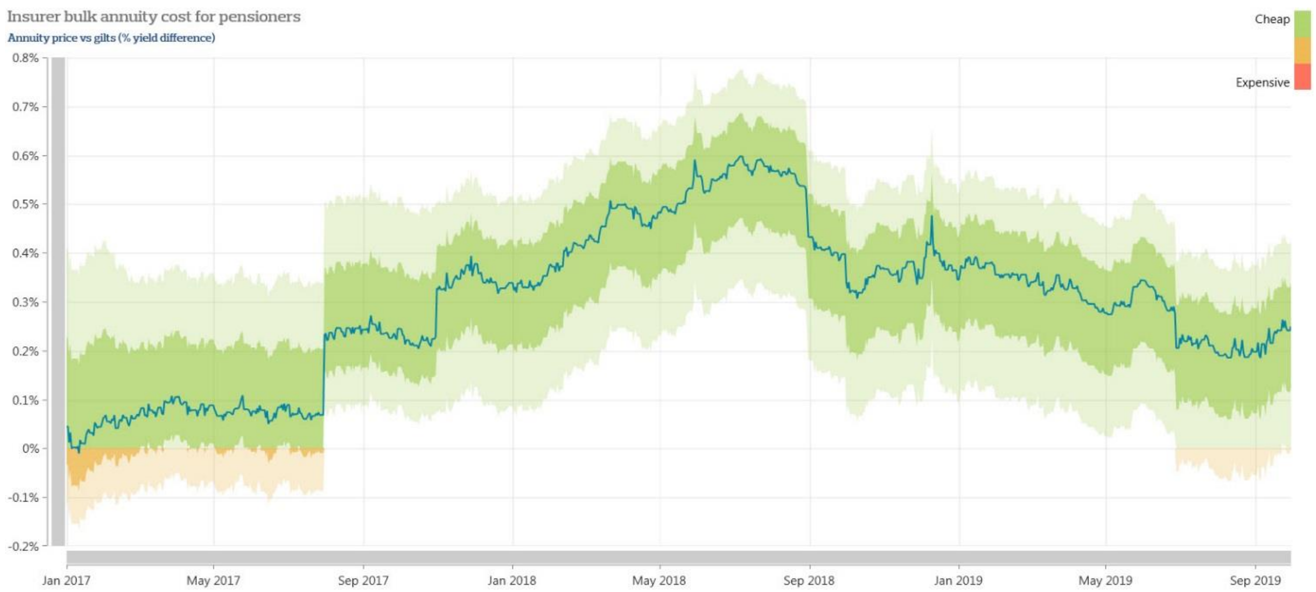
The chart below indicates the expected range of best pensioner pricing available in the bulk annuity market, for a typical scheme.

Pricing improved slightly in the latter part of Q3, partly driven by widening credit spreads, but also reflecting a slight fall in inflation expectations. This followed the Chancellor's announcement in early September, planning a consultation to align the calculation of RPI with CPIH between 2025 and 2030.

The second half of 2019 has been dominated by multi-billion transactions, with many of these grabbing the headlines. But pension schemes of all sizes have been achieving strong pricing in the market, despite many insurers appearing to be close to capacity for 2019.

The historically strong pricing experienced over the last number of years is expected to continue into next year. As the new year begins, insurers will have new capital opportunities and new business targets.

Schemes looking to transact should be preparing now to capitalise on the opportunities available in 2020.



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.
- A higher position represents a better price.
- This comparison ignores the material value from annuities giving a better hedge than gilts, including longevity cover.
- Expected pricing for a typical scheme is shown by the blue line.
- Prices typically fall in the darker shading, and some auctions fall in the lighter shading. Pricing outside the shading typically represents an unusual liability profile.

Chart sourced from Aon's Risk Analyzer

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Compliance approval code: A106-300420