For professional clients only

Aon's Investment Research and Insights

Should trustees buy in bulk?

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Aon
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Aon’s robust portfolio of ideas, tools and researched solutions supports trustees and sponsors to anticipate their future investment requirements.

By beginning to identify investment research and communicate ideas before they are needed we can shorten the implementation times for our clients and act in a timely way when opportunities are correctly priced.

To learn more and to access other research and insights from Aon’s investment experts, visit **aon.com/investmentuk**

Executive summary

A bulk annuity contract provides regular contractual income in exchange for a one-off premium paid to an insurance company. Bulk annuities play a crucial role in pension schemes seeking to de-risk.

Two forms of bulk annuity are **buy-outs**, and **buy-ins**...

In the case of a **buy-out**, the obligation to pay the benefits is **transferred from the trustees** to the insurer.

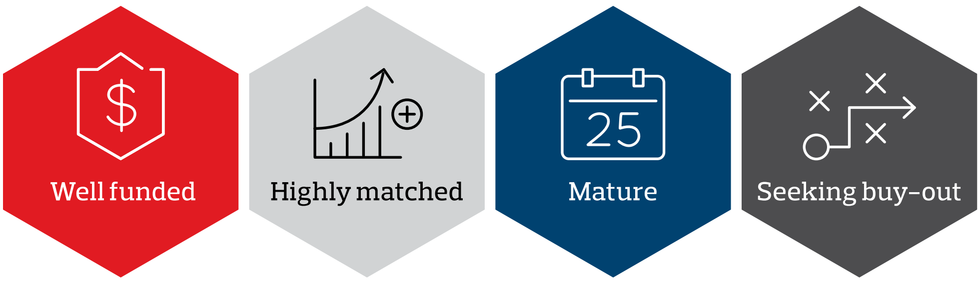
In the case of a **buy-in**, the insurer makes regular payments to the pension scheme matching the benefits insured. The liabilities are retained within the scheme and the **trustees remain responsible** for the payment of benefits.

This paper aims to:

- Define bulk annuities
- Identify the benefits to schemes
- Explain the use of annuities as a stepping stone to buy-out
- Discuss pricing

Suitability

A bulk annuity may be particularly suitable for your scheme, if your scheme has some or all of the following characteristics.



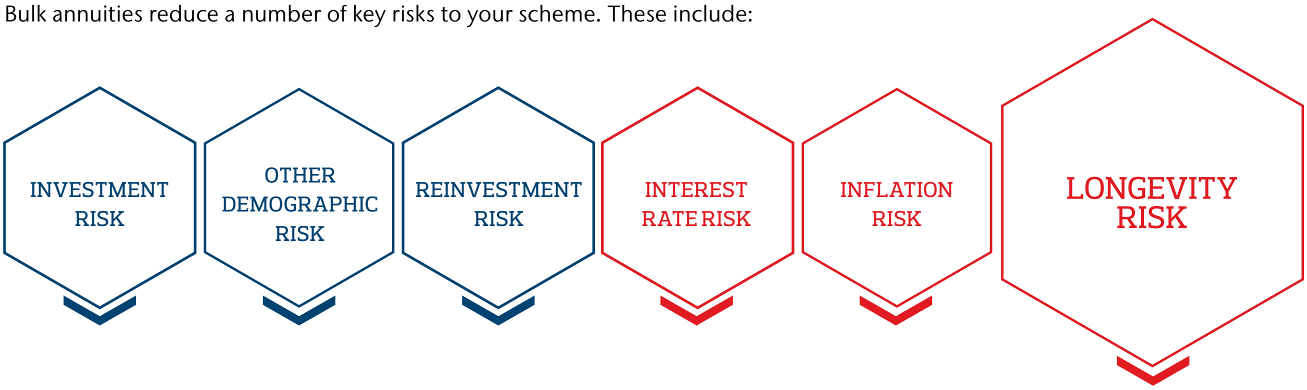
You may also consider partial bulk annuities to lock in a recent improvement in your scheme's funding level.

This paper will consider factors such as: corporate accounting position, scheme's long-term objectives and pricing in the bulk annuity market to provide insight to how bulk annuities could impact your scheme.

Why annuitise?

To mitigate risk

Bulk annuities reduce a number of key risks to your scheme. These include:



- Return on investment may be below expectations
- Factors such as marital status and spousal age can impact the value of liabilities
- Reinvestments may produce a lower return than initial investments
- The present value of liabilities increases as interest rates fall
- Increased inflation can cause a scheme to face higher-than-expected pay-out levels
- Increased life expectancy exposes a scheme to higher-than-expected pay-out levels

Risk matching

Key risk	Gilts/LDI	Bulk annuity
Interest rates	Good match (subject to duration)	Exact match
Inflation	Good match (subject to caps/collars)	Exact match
Longevity	No match	Exact match

Reduce governance burden

Maintaining a robust governance structure to manage the above risks is time, cost and labour intensive. A recent survey conducted by Aon's Risk Settlement Group suggested that buy-out is the targeted end game for 80% of schemes[1].

Through transferring the ownership of the commitment to pay scheme members, bulk annuities remain the only way for a scheme to demonstrate that, for a given tranche of pensioners, **all risk has been completely removed** from the balance sheet.

Longevity

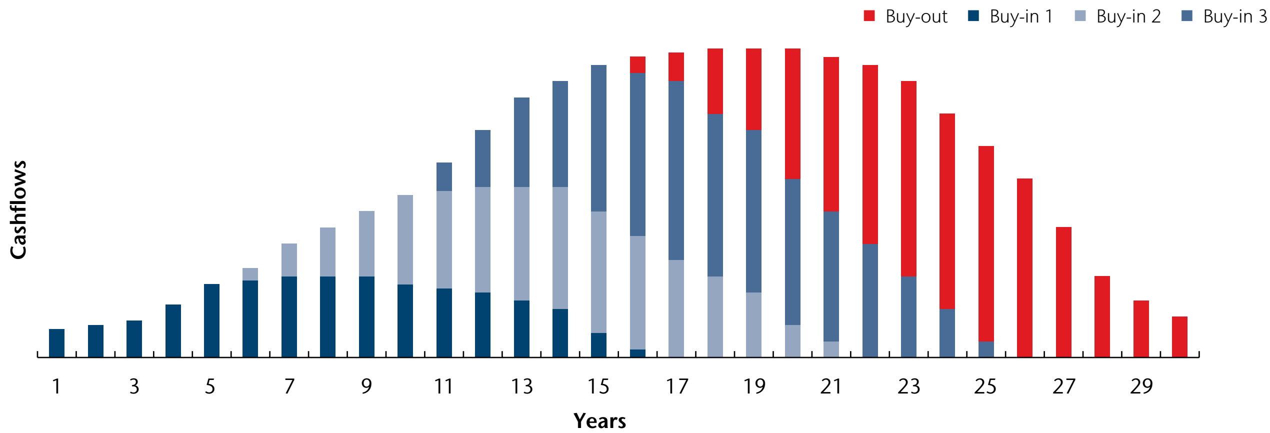
As your journey to buy-out or self-sufficiency progresses, longevity risk becomes a bigger concern. Unlike several of these other risks which can be mitigated almost completely with traditional Liability Driven Investment ("LDI") assets such as index-linked gilts and interest rate swaps, longevity risk cannot be easily hedged away. Longevity swaps are an option; however, the relatively attractive price of bulk annuities[2], greater complexity and availability for many schemes, has led to them remaining less popular.

1 "Aon Risk Settlement Market 2018: Long-Term Strategies", 2018 - Page 5.
2 See page 5 for further detail on bulk annuity pricing.

How buy-out could look for your scheme

If achieving buy-out is the desired end game of your scheme, a phased approach could allow you to integrate insurance with your existing investment strategy.

Liability cashflow profile



Phased buy-in approach illustrated on liability cashflow benchmark

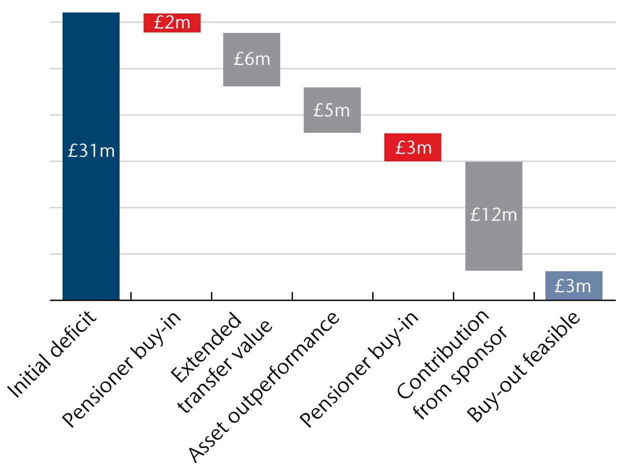
Phased approach

As illustrated above, schemes may annuitise tranches of pensioners, continuing to consider the residual portfolio and following up with future transactions until buy-out is feasible. Insurers offer favourable pricing to schemes that have transacted in the past.

Given that annuities provide a greater level of matching and risk reduction; schemes may be more equipped to bear the risk associated with higher yielding investments. This can lead to asset outperformance and help to reduce the funding deficit.

Member option exercises may be explored alongside annuities, further reducing overall scheme risk in a phased approach to buy-out.

Complimentary strategies – path to buyout



Consideration

When considering a buy-out, factors to consider include:

- **Funding position** – a scheme with a low funding level is unlikely to have sufficient available assets to purchase an annuity.
- **Investment strategy** – many schemes can significantly reduce risk through traditional liability hedging methods, rather than considering bulk annuities which are irrevocable so offer less flexibility for future changes to investment strategy.
- **Corporate accounting position** – bulk annuities typically worsen the pension scheme value on a company's balance sheet as they are discounted with a smaller basis compared to that of the scheme's liabilities (though this is not necessarily the case for US parent companies).
- **Target yield of the self-sufficiency 'end state' portfolio** – schemes that are targeting self-sufficiency should consider whether the expected yield on annuities is in line with the target yield of the end state portfolio.

Pricing

As well as providing a better hedge, purchasing an annuity is less expensive than the long run costs incurred with a buy and maintain strategy of gilts/corporate bonds to cover the annuitised tranche of pensioners.

When to consider bulk annuities

- If the cost of a bulk annuity is less than that of the underlying gilts required to match the projected cashflow profile.
- If trustees are willing to pay a premium for greater overall risk reduction.

Current market

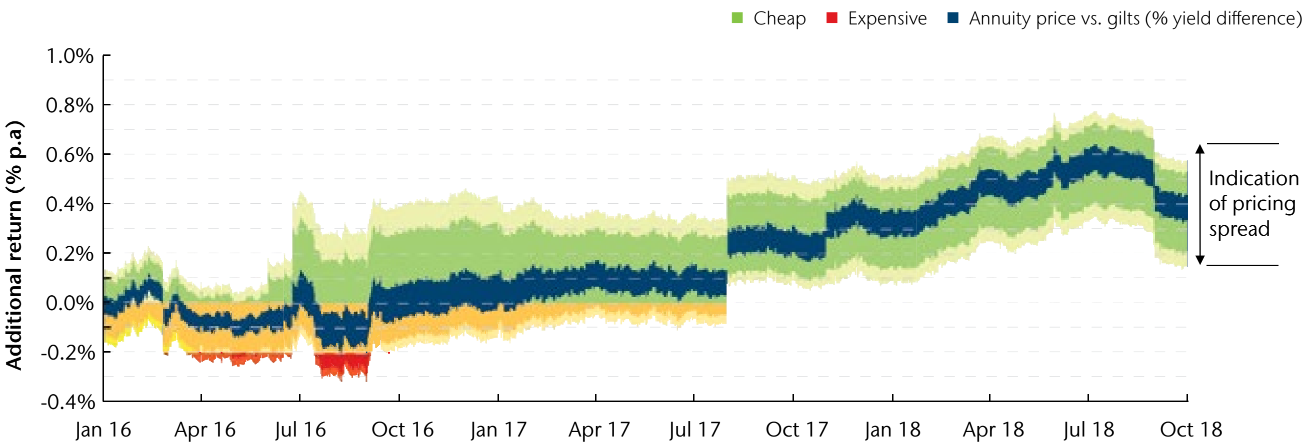
We currently expect a typical pension scheme to be able to achieve a yield of **c.0.4% p.a. above gilts on a bulk annuity contract** with some schemes able to transact at 0.4%-0.7% p.a. above gilt yields - measured on the solvency basis[3]. The impact on a technical provisions basis may vary.

The graph below illustrates the cost differential between an annuity relative to gilts.

Annuities remain attractively priced due to:

- Increased confidence among insurers using less liquid and higher yielding assets such as: commercial mortgages, equity release mortgages and infrastructure debt to back annuity contracts.
- High levels of competition between insurers looking to establish themselves in the marketplace and grow business volumes.
- Improving costs of longevity reinsurance to reflect recent longevity trends.
- Schemes that have already transacted through buy-ins typically have favourable terms in place for further transitions.

Insurer bulk annuity cost for pensioners



Source: Bulk annuity market monitor, Aon Risk Analyzer

COMPASS Aon have developed the platform "Compass" in order to obtain the best possible deal for schemes exploring bulk annuities.

The platform makes use of the rigorous preparation phase to provide transparency in order to increase confidence amongst all parties. Where pricing is below its expected level, the platform's innovative trigger mechanism ensures a scheme will be at the front of the queue when conditions improve[4].

[3] Yields stated as guidance as at the date of publication. Realised yields vary as per the above graph.
[4] Aon's Bulk Annuity Compass Platform: https://bulkannuitycompass.aon.com/

Conclusion

Bulk annuities may be preferred to gilts or UK investment grade corporate bonds due to their total risk reduction.

- When deciding whether annuities are suitable for your scheme, factors including your scheme's funding position, collateral requirements and long term objectives should first be considered.
- Falling annuity premiums relative to other low risk assets in the current market make bulk annuities increasingly attractive in comparison to the corresponding value of the required gilts or corporate bonds.
- If buy-out or low risk self-sufficiency is the long term objective of your scheme, there are a number of strategies you can utilise to get you to a position where this is feasible.
- Minimising your funding deficit is essential to the buy-out process. Alternative approaches to reduce the funding level deficit can be explored alongside a phased bulk annuity approach.
- Buy-out can be achieved once the scheme is willing and able to incur the cost of a premium greater than the total technical provisions.

Irrespective of current funding position and feasibility of full buy-out, we believe that bulk annuities should be considered alongside other strategies throughout the scheme's lifetime drawing you nearer to this end goal.

They may also be considered by schemes targeting self-sufficiency with a suitable end state yield target.

Contacts

John Belgrove
Senior Partner
john.belgrove@aon.com
+44 (0)20 7086 9021

Kate Charsley
Partner
kate.charsley@aon.com
+44 (0)117 900 4414

Tim Giles
Head of UK Investment Consulting
tim.giles@aon.com
+44 (0)20 7086 9115

With thanks to our author

Vincent Chawatama
Investment Analyst

About Aon

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Registered Office:
The Aon Centre
The Leadenhall Building
122 Leadenhall Street
London EC3V 4AN

aon.com

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