UK Risk Settlement

Quarterly newsletter – September/October 2013

Improved funding levels and a growing appetite to de-risk

2013 bulk annuities hits £5 billion already

A flurry of substantial deals over the summer means that the market has completed transactions passing the £5 billion mark by the end of September. This means this year has already seen as much business as transacted in the whole of 2012.

The market opened up over 2006 to 2008, thanks to new providers with new products, improvements in scheme funding positions, and attractive pricing encouraged by the investment returns available to insurance companies at the time. This led to year-on-year record growth, with £8bn placed in 2008. Five years ago though, the Credit Crunch and ensuing recession made transactions more difficult, with scheme funding positions proving more volatile, and liabilities hitting new peaks as yields fell, particularly in summer 2011.

2013 looks set to be the year when the bulk annuity market edges back towards 2008 levels, helped particularly by substantial placements with Pension Insurance Corporation and Rothesay Life.

We have summarised in the table below the bigger deals announced so far, including the largest UK buy-out deal to date – the £1.5bn settlement of the EMI scheme, following on from the £1.1bn settlement of the once related Thorn scheme in 2008, on which Aon Hewitt advised.

Providers have reported high volumes of enquiries from schemes. Some specific new stock issuances with attractive yields have helped providers to offer prices that are sufficiently attractive for schemes, despite a general fall in available credit spreads in the wider bond market this summer. The schemes that are able to take advantage of these pricing improvements will be those schemes that have already considered the feasibility of annuity purchase and are ready to transact.

With the total amount of credit being issued currently not sufficient to meet demand, the yields available to insurers are likely to be volatile in the short term, and we would urge schemes to get ready for settlement and to monitor market pricing.

The table below summarises the known large bulk annuities in 2013 to date:

Company	Insurer	Size	Comments
EMI	PIC	£1.5bn	Buy-out with full risk transfer
Not disclosed	Rothesay Life	£470m	Buy-in
Intercontinental Hotels	Rothesay Life	£440m	Buy-out with full risk transfer
Cobham	Rothesay Life	£280m	Buy-in
Not disclosed	L&G	£250m	Buy-out with full risk transfer
Smith & Nephew	Rothesay Life	£190m	Buy-ins for two schemes
Smiths Group	PIC	£170m	Fourth buy-in in de-risking programme
First Quench	PIC	£160m	Buy-out to take scheme out of PPF.

Full risk transfer back in vogue

Over 2007-8, the bulk annuity market saw a new product, a "full risk transfer", take off for some larger deals. This involves the insurance company taking on all of the pension liabilities in a scheme, but also addressing any remaining question of financial exposure for the sponsor, immediately on the day of the annuity transaction.

This is particularly helpful for a sponsor de-risking the pension scheme ahead of a potential business sale, as it allows the pension scheme to be completely excluded from the areas to consider in valuing the business. From a trustee and member viewpoint, the exposure to the covenant of the sponsor is addressed immediately.

A normal buy-out involves a post transaction process, to finalise the member database, address any residual inequalities in the scheme and secure insurance protection for the trustees themselves. The data improvements lead to an adjustment to the buy-out premium paid, and the process carries some implementation costs. This leaves a period where the employer has removed its key financial exposure under the scheme (including longevity, inflation and interest rate risk) at the time of transaction, but still has some exposure to further cost from the items mentioned. A full risk transfer removes some or all of this exposure, for the payment of an additional upfront premium.

Employers considering this should understand the steps involved pre transaction – the insurance company will need extra help and access to substantial information to help price the "full risk" cover reasonably.

As we have shown in the above table, three of the year's biggest deals transferred full risk.

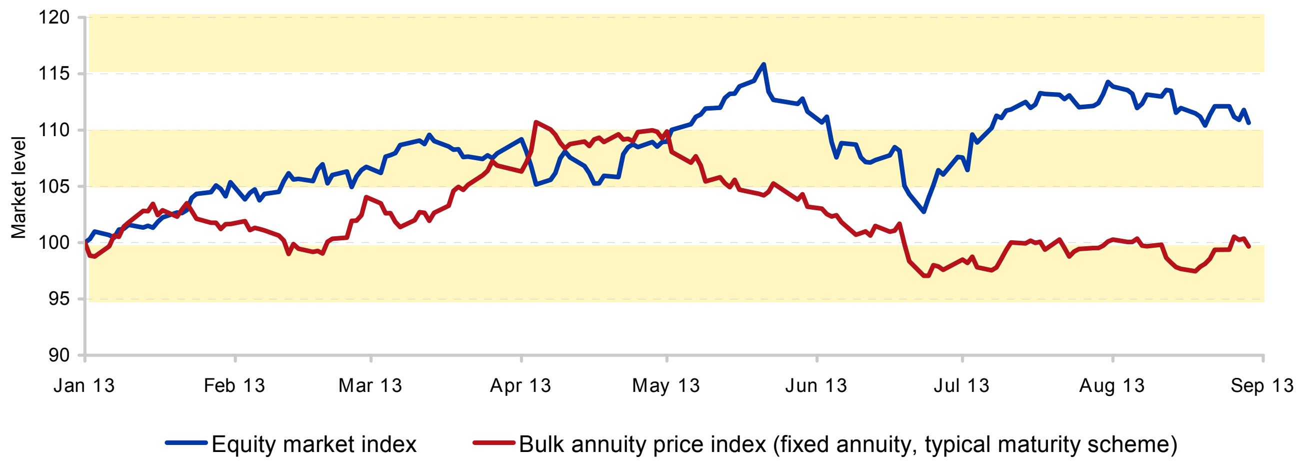
Funding gains sustained

With improvements in funding levels, more employers are finding scheme buy-outs – including full risk transfers – approaching cheque-writing distance.

2013 has seen, finally, some easing in the low yield environment, allowing liability valuations to ease from all time high levels, while there has been some scope for returns from growth assets overall this year. Schemes have reported funding level improvements of as much as 5% or even 10% this year, with the impact depending on their investment strategy and the extent to which they hedge risks. Some schemes are now starting to reach trigger points to partially de-risk their assets and lock in recent investment gains.

The graph below shows the performance of UK equities taken in isolation, compared with the change in buy-out cost, for an example scheme, and clearly illustrates the gains that have been made.

Bulk annuity prices vs equity markets



Medically underwritten annuities secure second foothold in bulk market

Four providers are offering new annuity products to the bulk annuity market, priced using health information relating to individual members. This approach gives a more accurate assessment of life expectancy and price. The key initial target market for this approach was smaller schemes securing their pensioners, with seven reported transactions so far.

But medically underwritten annuities can also be suitable for addressing concentration risk in a scheme – specifically securing those pensioners whose life expectancy is a major factor for financing the scheme.

Partnership has now reported its first such placement, a £22M transaction to secure the highest 20 pensioner liabilities in a scheme and remove material risk. This could open up a big target market for medically underwritten annuities, for schemes of a wide range of sizes.

Medical underwriting is available for a few hundred pensions in payment, or a smaller group, and we believe will now develop further. The providers have reported cost savings of as much as 10% or more from schemes that they have priced so far. Schemes should consider whether this could be relevant for them, and potentially affect their target level of funding.

Rothesay Life plans for changes

Goldman Sachs is to sell off part of its Rothesay Life insurance subsidiary, bringing in new investors. Discussions on new institutional investors are understood to be at an advanced stage, with Goldman Sachs expected to remain a major investor in the insurer.

Greater reserving requirements for banks investing in insurance companies could be one driver for the timing of this change. The new Basel III requirements for banks have been causing some reviews of bank business strategy, and other investment banks – such as Deutsche Bank, UBS and Nomura – having pulled back from participating in the UK bulk annuity market in recent years.

This comes at a period of successful growth for the Rothesay Life business, while the performance so far has allowed Goldman Sachs to take some dividend from the business while still leaving its solvency margins at high levels.

With PIC receiving substantial new investment from the Reinet Fund last year, Partnership announcing an IPO and the Lucida book being taken on by Legal & General, the last twelve months have seen some material changes in ownership of bulk annuity insurers.

For once, a *fall* in life expectancy

The UK has a strong record of monitoring its experienced mortality. One key reason for this is the work of the Continuous Mortality Investigation, run by the actuarial profession and currently chaired by Aon Hewitt's Tim Gordon. The CMI publishes annual information on the UK's experience, taking into account the latest information on deaths. Generally, as in other countries, life expectancy has been increasing substantially for the population on average.

However 2012 proved unusual, with a heavier volume of deaths (adjusted for age and sex) than in 2011.

The data provided by the CMI, together with projections of future improvements in mortality rates, is used by actuaries to value pension liabilities. This new information is expected to reduce scheme liabilities by around 0.5-1%, just from taking into account the latest year's death information.

The table below shows how volatile mortality improvements have been in practice. Actuarial valuations tend to allow for *future* improvements in life expectancy to settle down to about 1.25-1.75% per annum. The table illustrates how uncertain this key assumption really is, and hence illustrates the value from transferring longevity risk out of a scheme, under a longevity swap or annuity.

Observed crude annual mortality improvement rates for England & Wales population ages 65-102

Source: CMI Working Paper 69

Year	Male	Female
2001	+3.3%	+1.7%
2002	+1.2%	−0.2%
2003	+1.9%	−0.7%
2004	+5.5%	+6.4%
2005	+2.6%	+0.8%
2006	+3.9%	+4.1%

Year	Male	Female
2007	+2.3%	+0.7%
2008	+1.4%	+0.1%
2009	+4.7%	+6.4%
2010	+2.3%	+0.8%
2011	+3.7%	+3.7%
2012	−0.4%	−2.6%

Solvency II finds even longer grass

The revised solvency standard for insurance companies still has no clear implementation date. A key European debate covering how insurers are to reserve for long-term guarantees such as annuity commitments has now been pushed back into 2014. This is at the heart of the implications of the standard for annuity business, and leaves the scope for practical progress on preparation still limited.

Banking body questions the capacity for settling pension risk

The Bank for International Settlements, a body representing the world's central banks, has raised questions about the scope for the financial system to absorb longevity risk.

It has issued its consultative report, mentioning estimates of global longevity exposure from pension promises of perhaps $15 trillion to $25 trillion.

With populations ageing and pension funds looking to hedge their longevity exposure, this raises the question of how much risk can be borne elsewhere. The UK and US settlement markets have led the way in transferring risk to the insurance and banking sectors, although longevity markets are now being considered in several other countries. The paper provides a welcome introduction to the wider issues faced by this risk, but we do not see evidence of market capacity proving a practical issue in the near term.

The market does need sufficient direct writers and reinsurers to provide capacity, and there may be occasions when one of these two parts – perhaps more likely the direct writers – cannot satisfy scheme demand for de-risking. We believe this will lead to innovation and new entrants but – given the settlement market is dwarfed by the unsecured liabilities remaining in schemes – there could be periods when placement is only possible at a temporarily higher price. This is one driver for taking advantage of market opportunities when available.

Contact

If you would like further information on the bulk annuity market, please contact your Aon Hewitt consultant or alternatively one of our advisers on the Risk Settlement Group: -

Martin Bird	020 7086 9027	martin.bird@aonhewitt.com
Dominic Grimley	0121 262 5094	dominic.grimley@aonhewitt.com
Paul Belok	020 7086 8089	paul.belok@aonhewitt.com
Tim Gordon	0121 262 5043	tim.gordon.2@aonhewitt.com