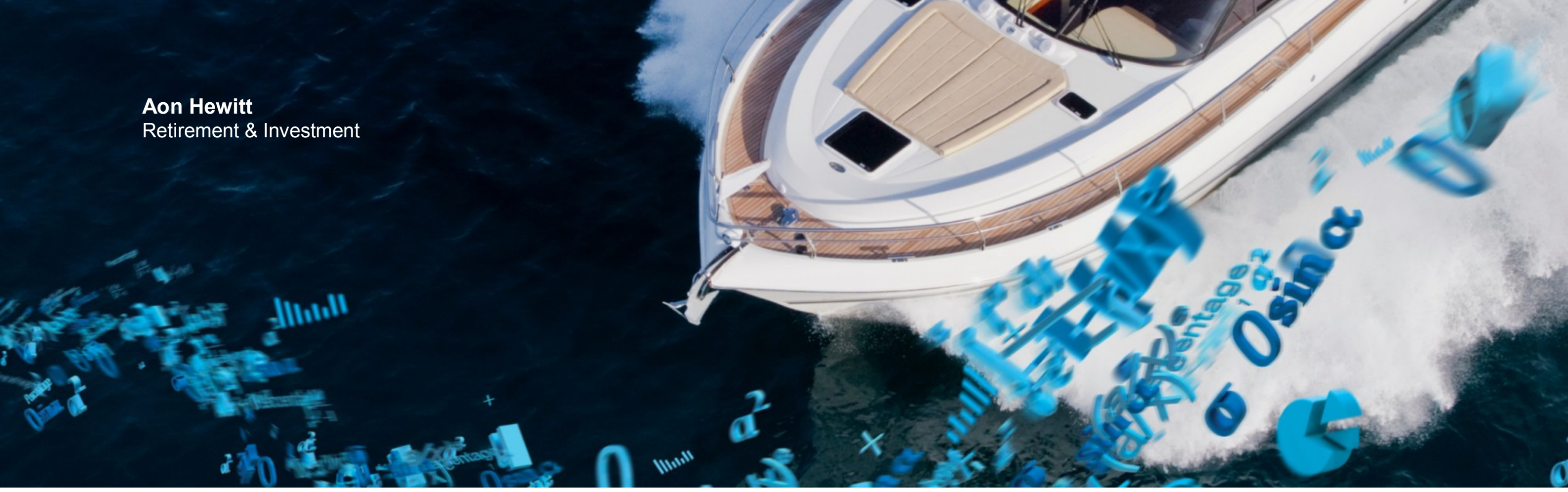


Aon Hewitt
Retirement & Investment

UK Risk Settlement

July 2018

Annuity yields remain high relative to gilts

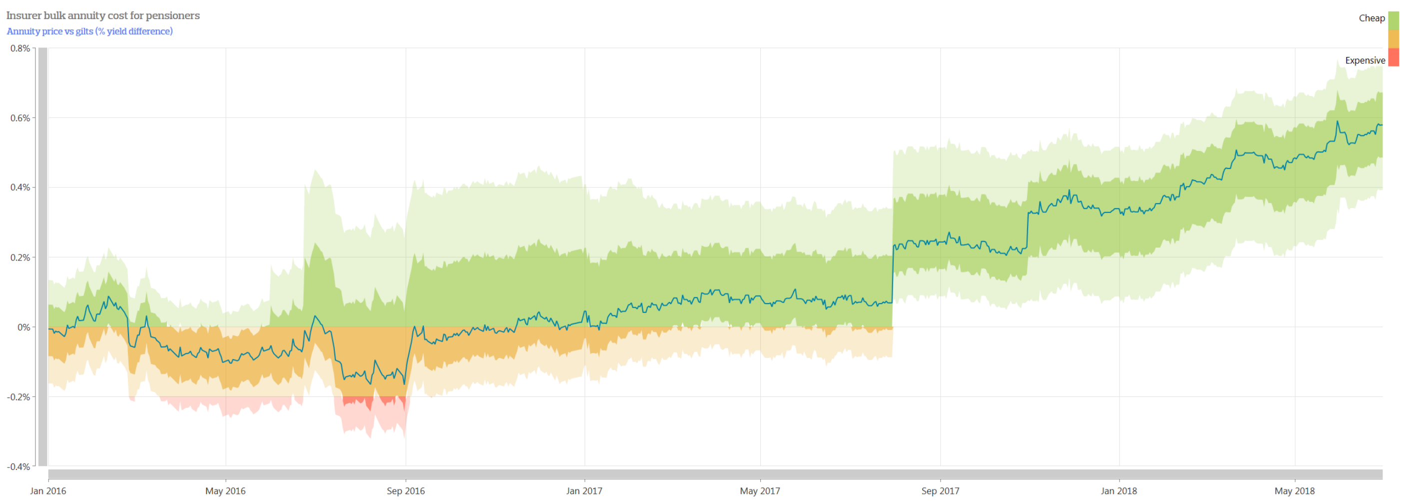
Keen followers of pricing in the annuities market will know that the cost of a buy-in investment has been particularly attractive since Summer 2017. This is largely driven by market competition, favourable market conditions and asset opportunities available to insurers. The result has been a sustained opportunity to move assets out of gilt or LDI mandates and into an annuity for an improved investment yield. Hence, for many schemes holding safe harbour assets, there has been a compelling investment argument to purchase an annuity.

A buy-in at current prices may even generate a profit relative to a long-term (typically gilt-based) funding target.

The chart below shows the implied return on a pensioner buy-in relative to gilts since the beginning of 2016 - the point at which the Solvency II insurance regime came into force. After a short period of "bedding-in" and the market disruption caused by the Brexit Referendum in June 2016, the yield on an annuity has - unusually - showed a continued improvement.

The pricing improvements seen in 2018 are not just down to actions taken by insurers.

The upwards trend in implied yield on an annuity, when assessed relative to gilts, has been helped by the diverging metrics used by insurers and pension schemes to price risk.



How to read this chart

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

Chart sourced from Aon's Risk Analyzer

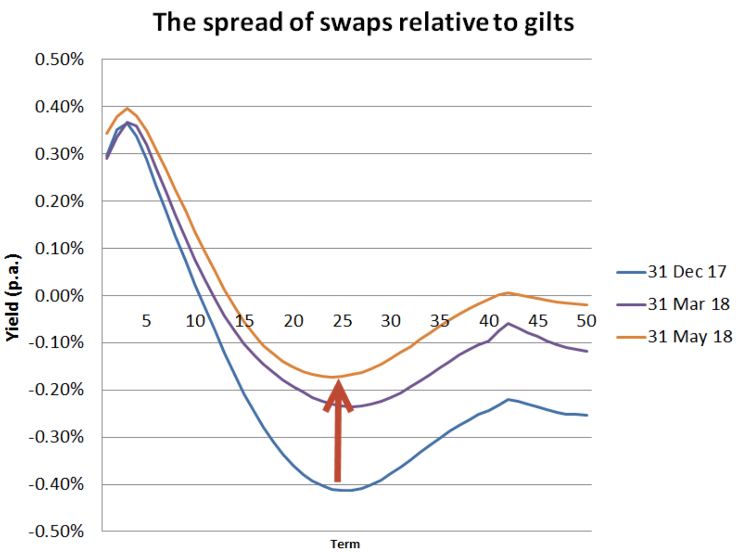
Insurance companies measure the yield on their portfolio relative to swap yields, as a measure of "risk-free" return. In contrast, most pension schemes continue to measure performance relative to a gilt-based measure.

Consequently, schemes assessing annuities as a substitute to gilts will see changes in the relative yield available from these two asset classes, when the swap and gilt markets move differently.

The chart below shows that the gap between swaps and gilts (also known as the "z-spread") has narrowed over 2018. This continues a trend since summer 2016, at which point gilts offered a yield materially in excess of swap yields. This trend has steadily improved annuity pricing relative to gilts.

Insurers invest in a variety of credit instruments ranging in quality and origin, selectively picking stocks that best fit their portfolios and offer further pick-up in yield.

The additional yield available from corporate bond investment has started to improve recently. Combined with the comparatively attractive yield on illiquid asset opportunities acceptable to insurers, this has also helped generate attractive prices for a pensioner buy-in, with a "gilts plus" yield achievable.



Bulk annuities market in 2018

At the start of 2018, we predicted that this would be a record year for bulk annuities – quoting that £30bn of risk could be transferred by the end of the year.

We have already seen large publicised deals for part of the Prudential annuity book (Rothesay Life, £12bn) for Siemens (the largest pensioner buy-in so far in 2018, at £1.3bn) and PA Consulting (the largest buyout so far this year, at £850m), among others. We arranged these latter two transactions with PIC recently.

Hence we remain confident that the market is on track to hit our estimate. The first 6 months of 2018 has been the busiest period since the pre-Credit Crunch 2008 market, and more fruitful in terms of resulting volumes placed.

But can this continue for the remainder of the year?

Capacity constraints have long been a concern, but never really tested in anger. At present access to capital and willing risk-takers for longevity risk are not constraints. Factors that can cause short-term constraints for individual providers are access to sufficient high yielding illiquid assets to drive competitive pricing, and free experienced resource on the pricing team. This is reflected in greater selection applied by insurers before deciding to quote on a new auction. In particular, providers are clearly limiting effort on more speculative or indicative quotations, such as pricing platforms used by schemes that are not necessarily well-positioned as yet to transact. In a market where insurers are selective and have the luxury of choosing in which auctions to participate, it is the well-prepared schemes that are likely to experience the best outcomes.

One notable feature this year is that several providers have already written their largest ever deals, showing the improving ability of the market to take on substantial risk effectively.

Landmark deals already disclosed in 2018

Transaction	Insurer	Comment
Siemens - £1.3bn buy-in	PIC	Largest buy-in disclosed in 2018 (Aon advised)
PA Consulting - £850m buy-out	PIC	Largest buy-out disclosed in 2018 (Aon advised)
Prudential - £12bn backbook	Rothesay Life	Largest ever transaction by a bulk annuity provider
Littlewoods - £880m buy-in	Scottish Widows	Largest ever transaction for Scottish Widows
Marks and Spencer - £925m buy-in	Aviva	Largest ever transaction for Aviva
Marks and Spencer - £470m buy-in	Phoenix Life	First external transaction for Phoenix Life

Depending on the outcome of some current auction processes, we expect three more insurers to have written their biggest ever bulk annuities shortly.

Whilst there is scope for pricing to harden if high demand is sustained through the autumn, attractive pricing has still been achieved in recently completed auctions and the favourable market conditions remain supportive of annuities offered a yield in excess of gilts.

The improved market of 2017-2018 has attracted a new wave of pension schemes to the market. As these schemes are also seeing significantly improved solvency positions, partly from the same favourable changes in market conditions, this trend is expected to continue for some time, and the focus on achieving the full buy-out goal will grow.

If you have not considered your own scheme's solvency position recently, you may get pleasant news from exploring it. Our *Risk Analyzer* software allows clients to get real-time updates on their improving position, direct from their phone or tablet.

Change in equity release valuations could impact annuity pricing

The Prudential Regulatory Authority (PRA) is considering a strengthening of solvency requirements for insurers holding Equity Release Mortgages (ERMs). It launched a consultation on 2 July 2018.

ERMs are an illiquid asset class that are currently used by a number of bulk annuity providers to both provide a match to their long-term liabilities – they qualify for favourable reserving treatment – and delivering a yield above that attainable on a standard bond portfolio.

Most of these mortgages include a “no negative equity guarantee” element, which prevent the insurer from claiming against other assets of the borrower if the value of the underlying property has fallen below the amount borrowed when repayment is due (typically on death). The risk to the insurers is reduced by:

1. Diversifying the properties covered geographically;
2. Restricting loans so that the “loan to value” proportion is low, typically 25%-35% on average;
3. Avoiding large loan amounts.

The guarantee is still a risk for insurers if there are substantial sustained falls in property values. The PRA is considering the reserves held in recognition of this risk.

The proportion of ERM assets within the existing asset portfolio, and the extent to which they back new annuity business, varies by insurer. The use of this asset has been growing as its yield has become very attractive compared with other assets appropriate for backing annuities.

If the new reserving requirements for ERMs turn out to be stronger than an insurer's current practice, their solvency position may reduce (although the PRA discusses a transitional period of up to 3 years in the consultation). It is worth noting that as all current bulk annuity insurers typically hold contingency margins well in excess of statutory requirements (c150% on average), the impact of this may be limited in absolute terms, but schemes do need to be cognisant of the impact.

This may act to inhibit pricing from some insurers (if they back a significant proportion of new business with these mortgages, as a firm preference over other asset opportunities) until this debate concludes.

Arguably, the consultation should be well received as evidence that the PRA is monitoring risks inherent within the insurer market on a dynamic basis. Past experience, most recently following the introduction of the Solvency II regime in 2016, has shown that insurers have been very proactive at evolving and developing solutions to fit the regulatory and financial environment in which they operate to service the demand from pension schemes for buy-ins and buy-outs. Indeed the unprecedented pricing of the last 18 months followed (incorrect) market predictions of price increases consequent of Solvency II of “up to 10%”.

While the consultation is on-going, we would warn against drawing drastic early conclusions on how the market will evolve.

How far off is buy-out?

With insurance pricing looking very attractive, many schemes are looking much harder at the previously aspirational target of funding to fully secure all benefits, i.e. to attain "buy-out". But how should schemes assess the time horizon to buy-out without knowing how insurers will price their risk profile in the future?

The timing of buy-out is harder to predict than other end-game destinations with neither the insurance markets nor the scheme's funding position or maturity ever standing still. In particular, understanding how insurance pricing evolves for a maturing scheme – like the example shown in the chart below - is not a trivial task.

To get a handle on how the cost of buy-out develops over time we should consider the following:

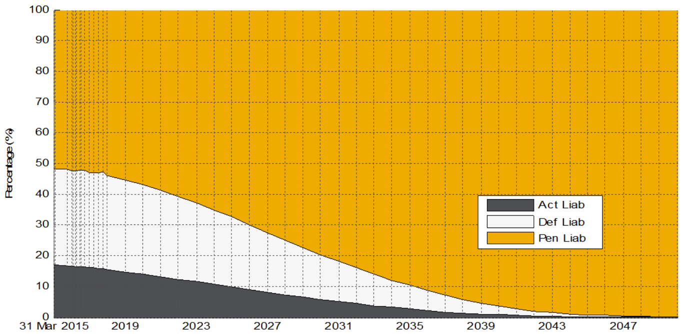
Pensioners are cheaper to secure than deferred members

As members retire, their future cash-flows become more certain, making it easier for an annuity provider to price and reinsure their risk. In practice, this means that schemes will see a profit relative to buy-out with each new retiree.

In addition, members will take part or all of their benefits as retirement cash sums or transfer values. In the large part, the terms on which cash is offered to members is less than the amount reserved for under a "buy-out" estimate – again resulting in a funding improvement whenever cash is taken. With significant numbers of members taking transfers and exercises to notify members of the opportunity to retire early, the change in membership will materially affect the profile of the scheme, significantly reducing the cost of buy-out over time.

Asset strategies of pension schemes and insurers both evolve in a way to make insurance look more attractive

Schemes in an advanced stage of maturing (with the risk profile becoming increasingly dominated by pensioner liabilities) need to regularly monitor their asset strategy. Over time the scheme's cash-flows become increasingly negative as a result of the growing pension payroll, especially as deficit



funding ceases. This net outflow of cash may restrict the extent to which asset returns bring buy-out nearer and drive the need for liquidity.

But for an insurer this maturing means that the projected cash-flows become shorter over time, which may improve the asset yield attainable from suitable duration matching investments. For shorter duration assets, the insurer's reserving requirements are also less penal in terms of the market yield that can be reflected and passed on to purchasers.

Non-pensioners also get cheaper to insure over time

Compared with buying-out now, securing the deferred members later also defers the date when risks are fully hedged with an insurance company. Risk protection is then paid for in respect of a shorter period, reducing its cost.

For example, inflation-linked pension increases, which often contain a complicated set of minimum and maximum levels, can be difficult to hedge and so comparatively expensive to secure, particularly for deferred members. The cost of securing them decreases with maturity as there are fewer increases to benefits then left to consider.

Similarly the cost of longevity hedging may fall with maturity, and – in the current markets – there is more competition for longevity reinsurance for the residual part of a scheme once the deferred membership has matured and shrunk.

…so buy-out may be closer than you think

With a solvency estimate only useful for a limited time due to the way pricing matures, we often see schemes underestimate their current buy-out costs if using approximate methods to "roll-forward" past results. This is further compounded if you don't fully reflect the latest pricing from the insurance market. So much so, schemes that were 85%+ funded at their last formal solvency valuation might now be within affordable reach of buy-out.

Longevity swap market is back in business – National Grid secure a £2bn longevity swap

There has been much attention in the press in recent years as to whether the price offered by reinsurers to hedge a scheme's longevity risk is good value. At the forefront of this argument, Aon publicly called out reinsurers in late 2016 for not reflecting the recent slow-down in longevity improvements. The "dis-location" of pricing on deals was significant and, as a result, we advised a number of schemes to pause whilst reinsurance pricing caught up with the latest information.

Two years later, pricing has largely "re-located" and deals are back on. An example of this is the recent National Grid deal: a fully intermediated £2bn longevity swap covering pensioners of the National Grid Electricity Group of the Electricity Supply Pension Scheme, with Zurich acting as intermediary and Canada Life Re providing reinsurance capacity.

What made a longevity swap the right solution for National Grid?

Pension schemes will look to hedge longevity risk for a number of reasons. Some schemes will only look to an annuity insurance solution as this essentially takes care of all the pension scheme's risks for the population for which cover is secured. However, annuities involve handing over a significant sum of assets that could have a number of uses if retained by the scheme – typically seeking a return to fund a deficit, or leveraged protection against interest rates and inflation movements over a wider population.

National Grid concluded that such investment constraints meant a 'funded' annuity was not appropriate to meet their de-risking objectives in the short term. However, the longevity risk inherent in their pensioner population remained significant and so opportunities in the longevity market were explored. A longevity swap is an 'unfunded' structure – no assets change hands at the outset. National Grid's investment strategy is therefore relatively unaffected.

How did National Grid secure attractive pricing?

This transaction was one of those that lived through the longevity reinsurance price "dislocation" to "relocation" journey.

Initial pricing in 2016 was not seen to be favourable when assessed relative to the emerging mortality trends. Had National Grid transacted at the time, they essentially would have paid for the cost difference arising between the CMI_2014 and CMI_2016 longevity improvements models – approximately £40m.

After significant market pressure on reinsurers to realign pricing generally, a robust auction process by Aon led to significant interest in the National Grid transaction, with multiple reinsurers chasing the deal in Q3 2017. Final pricing clearly demonstrated that pricing had relocated, with the cost of the swap reducing by £40m, and meeting the agreed price metrics based on an up-to-date view of scheme members' life expectancies.

The fully-intermediated structure and a new step for Zurich

The primary capacity and appetite for taking on UK pension schemes' longevity risk comes from the global reinsurance market, not from UK insurers.

However, pension schemes cannot enter into reinsurance contracts. An intermediary entity is therefore needed to 'transform; the reinsurance, typically into an insurance contract which a scheme can enter into.

A variety of intermediary options exist, with different costs, risks and obligations for the scheme These range from:

- A regulated UK insurance company being the pension scheme's sole counterparty, managing the contract and retaining the credit risk of the reinsurer - a 'fully intermediated' structure, to;
- The scheme setting up and running their own insurance vehicle (most likely located in an offshore location, e.g. Guernsey or Bermuda, for capital reasons), taking responsibility for managing the governance and administration of the swap, and various associated risks. This 'self-intermediated' model was used by the BT scheme for their £16bn longevity swap executed in 2014.

We advised National Grid on the pros and cons of each option, balancing the difference in cost (both headline, and less obvious) with the risk and governance implications for the trustee and sponsor.

The conclusion that National Grid reached was a fully intermediated solution, partnering with Zurich to develop their prior mid-market offering to a bespoke arrangement for National Grid, with various important commercial terms being negotiated by Aon – for example 'future-proofing' the contract for various future developments, including a clear route to an annuity purchase as and when the time is right for the pension scheme.

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