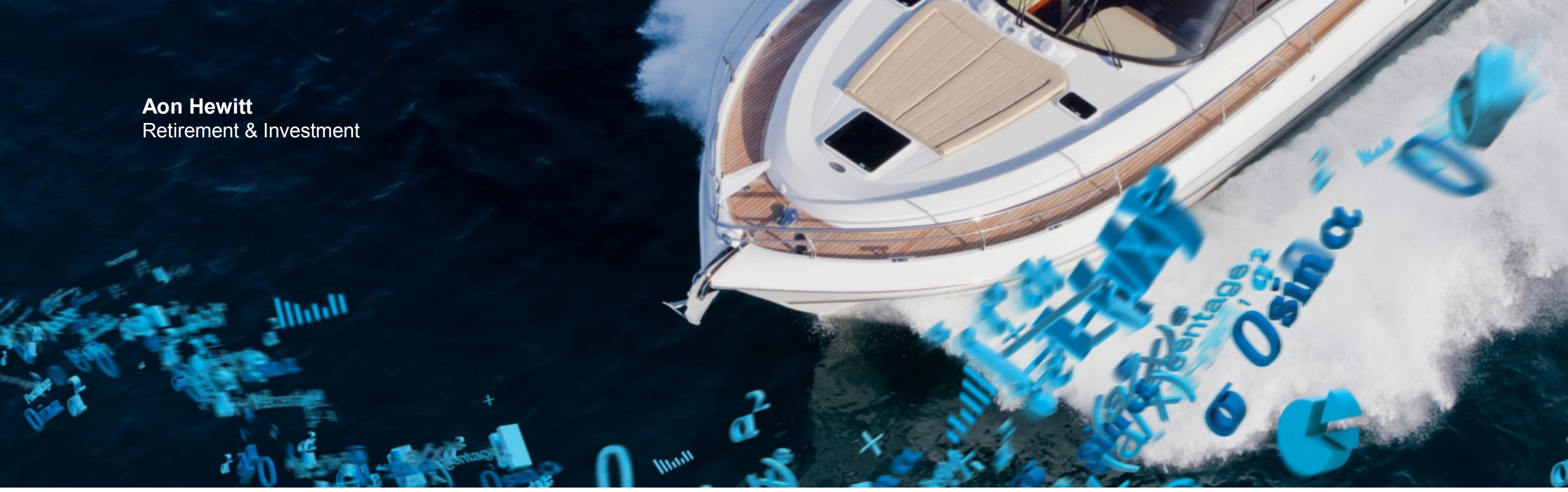


UK Risk Settlement

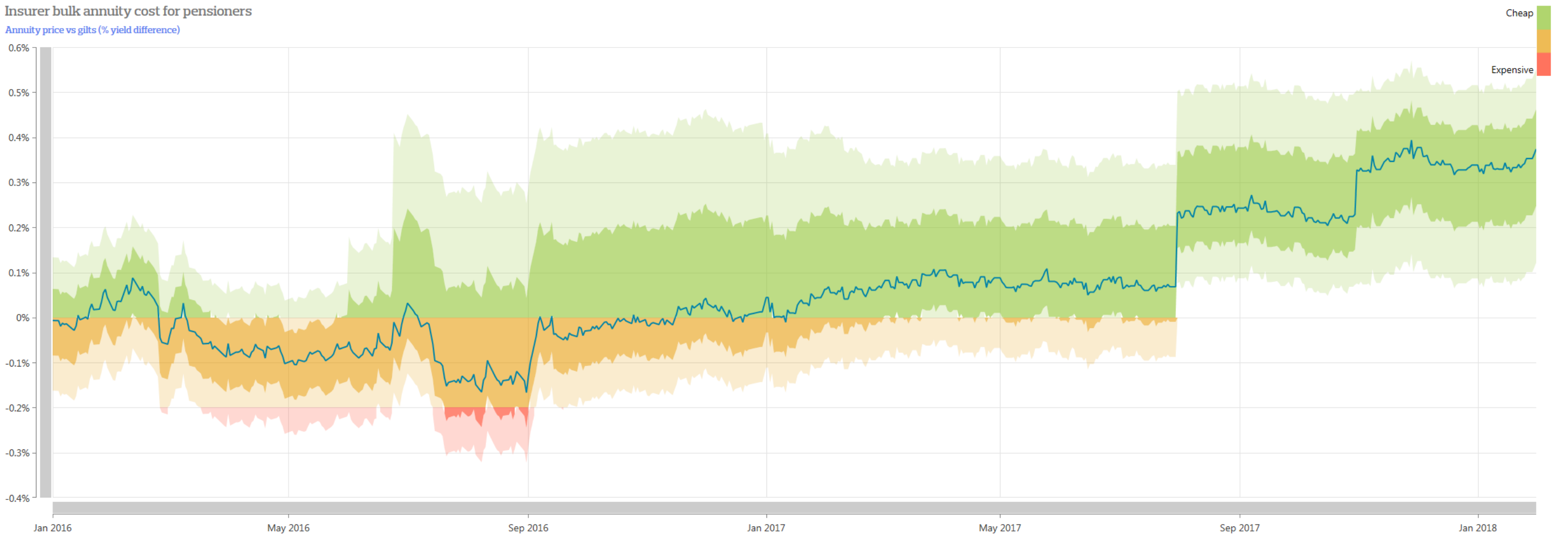
February 2018

Pricing Opportunity Continues

As the graph below shows, annuities are continuing to deliver notably better yields than comparable low-risk assets for pensioner transactions. Pricing improvements over 2017-2018 reflect illiquid and private asset opportunities for insurance companies, a strong market supply of capacity, and attractive longevity reinsurance.

For an auction to be a success, a close eye on market developments is key, together with a clean, well-run process, with well-defined objectives and price targets for execution. In a busy market, the providers continue to be selective about which processes to invest their resources in, as pricing teams only have so much bandwidth to deliver initial quotations and then be able to focus on the detailed implementation work to ensure that deals get over the finish line in a timely fashion.

While the market has started with an unusually busy Q1 – perhaps the busiest since 2008 – most deals are expected to conclude in the following three quarters. The market remains keen to consider further schemes for well-planned auctions.



How to read this chart

- This shows the return from a bulk annuity for pensioners, relative to the yield on a comparable gilt portfolio
- 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

A Brexit Impact?

While it is difficult to draw firm conclusions with so much still to happen, there are no expectations of a material impact on the bulk annuity market from Brexit:

- Firstly, the insurance companies have diversified their asset holdings further across territories and sectors, reduced exposure to very low or nil levels in deemed weaker European countries' sovereign debt, and invested materially in direct asset opportunities like infrastructure and social housing that are less sensitive to movements in wider markets.

- Secondly, the regulatory regime that the UK had already voluntarily adopted pre 2016 was similar to the EU-wide 'Solvency II' regime imposed in 2016. Solvency II generally involved more changes in approach for non-UK insurers, although it was material for all countries.

- Several of the main UK insurers have significant operations across multiple countries in Europe and elsewhere, and it will be essential to the industry that they are recognised as having appropriate solvency restrictions by these other countries post Brexit. It is therefore expected that the UK would continue to follow Solvency II or something extremely close to it in practice.

Clearly there will be some extra market volatility from the continued uncertainty as to the form of Brexit. This could act in either direction for viability of annuity transactions, but the period from autumn 2017 to date has been relatively benign for completing annuity purchases.

GDPR Affects Annuities

Like pension schemes, insurers are also planning for the increased regulation of data security under the GDPR requirements effective from May 2018, for their annuity books.

Amendments to existing annuity contracts are likely to be needed, to comply with GDPR, where the contract continues to be held in the trustees' name as a buy-in. At present the form of amendment required is still under consideration for most insurers.

As the insurer will be holding some scheme data, their policies on the handling, storage and sharing of information are also relevant considerations as part of the scheme's review of compliance with GDPR. We would regard this as more a point to check, than one where we expect any issues to arise, given that tight governance already applies to insurer handling of data, and existing annuity contracts already contain substantial provisions on data protection.

Depending on the nature of the annuity policy, it is also possible that the insurer as well as the scheme will want to communicate with members to explain how they handle data, in which case a joined-up approach to communication is preferable.

Illiquid Opportunities Could Restrict Flexibility

For annuity providers, the hunt for yield has led increasingly to exploring more illiquid, often privately sourced, asset opportunities. This partly reflects uncertainty over the scope for dramatic further outperformance in the more developed listed markets. This trend has also started to develop more for pension schemes, with a potentially better risk-return balance available by widening the scheme's asset capabilities. However, this can come at the expense of locking into asset holdings for a long period, with no automatic route to early redemption or quoted sale price.

Opportunities include private debt (with a developing Collateralised Loan Obligation market), property (where yields are generally found to be holding up better than in the bond markets), and infrastructure (with an increasing range of listed opportunities, in addition to existing direct private investments).

Some of these investments have lock-in periods of as long as 10 years, and some infrastructure investments draw down capital from the investors in stages, so more funds would be added to the initial investment in time.

While both pension schemes and annuity funds are long-term investors, there is growing uncertainty over the run-off period for many closed pension schemes. Often these schemes are dominated by 'deferred' members who are not accruing or drawing benefits. Since the introduction of the Pensions Freedoms regime, there has been a significant rise in transfers out of schemes from these members, accelerating the maturing of the scheme and reducing the time to the red-letter day when the scheme is able to afford a full buy-out.

This date has historically been notoriously hard to predict, and long-term projections often prove to be considerably conservative in deriving an accurate estimate. This is partly because the maturing of the scheme has several different impacts on improving the affordability of buy-out over time, some of them relatively subtle and hard to model. In addition, the sponsor may well later conclude that it has reached 'cheque-writing distance', where a relatively small residual deficit would be paid-off, noting the gain this achieves in ceasing future running costs earlier. However, from a negotiating viewpoint, the sponsor may not wish to reveal any scope for final funding early on. Overall we suggest that this means that the timescale to buyout is often over-estimated by a substantial number of years.

To date, this has been a relatively abstract point of debate for many schemes, as buyout has previously been over 10 years into the future under any estimate. However, asset returns, the introduction of member option programmes and better annuity pricing have together reduced these deficits materially in recent years and so many schemes find themselves much closer to buyout than they expected.

Pension schemes considering investing in more private and illiquid asset opportunities need to think carefully about how this interacts with their path to buyout, and in particular an assessment of the shortest possible lifespan of the scheme should be made. The scope for passing illiquid assets to an annuity company on buyout also merits consideration, but may prove challenging if the scheme's allocation to each underlying asset is small.

While many schemes are not currently targeting buy-out, stake-holder views on the long-term objective often do change as maturity increases materially. So a balance is needed between flexibility to access scheme assets as soon as buyout is affordable, and making the most of opportunities for growth asset allocation.

Buyout Case Study - Incorporating Member Options with Annuity Purchase

We have consistently seen favourable annuity pricing over the past 12 months. Considering 2017:

- Attractive prices were on offer from every insurer, and every deal we completed in 2017 was closely contested by multiple insurers;
- The best yield on offer proved similar on transactions from £15m to much larger sizes, although the most competitive insurer varied by size;
- Compared with the previous year, significantly improved pricing applied to both pensioners and deferred members, with price reductions of 10% in 2017 compared with 2016.

As a result of the above, solvency deficits in most schemes decreased sharply. In some cases, this meant that a successful member options exercise might release the funding needed to make full buyout affordable.

Bulk annuity providers are increasingly comfortable with member options exercises, and subject to some conditions, can allow for the savings resulted from them post transaction, if the members in scope are first insured under a bulk annuity contract. This allows trustees to enter a bulk annuity contract earlier than would otherwise be the case, reducing the risk of annuity terms worsening over the period while the member options exercise is run.

Below we share a case study of one such case.

Agreed objective

This was a mature scheme, closed to new entrants and benefit accrual for a number of years. The sponsor was unhappy with the uncertainty and volatility of future contribution requirements, while the trustees had concerns about future governance as repeated appeals for new trustees had received limited response.

Given the reduced deficit, the sponsor decided to target buyout and was willing to pay extra contributions to fund some, but not all, of the buyout gap. The trustees were happy with the objective, but required reassurances about the administration of benefits post buyout.

Actions

We provided detailed due diligence on the bulk annuity market, including an assessment of administration capabilities, in order to identify suitable counterparties. Initial quotes were then obtained to establish whether pricing was attainable.

This proved to be the case, and bulk annuity terms were agreed with the preferred insurer; the annuity was structured alongside the member option exercise and completed in two stages:

- A policy covering pensioner members secured first, concurrent with a pension increase exchange (PIE) offer to pensioner members. Post PIE benefit changes were allowed for in the calculation of the adjustment premium.
- Contractual terms were agreed for the deferred member population, with premium payment deferred until completion of the enhance transfer value (ETV) exercise. Pricing was monitored throughout the period that transfers were offered.

Outcome

This gave a positive outcome for all parties.

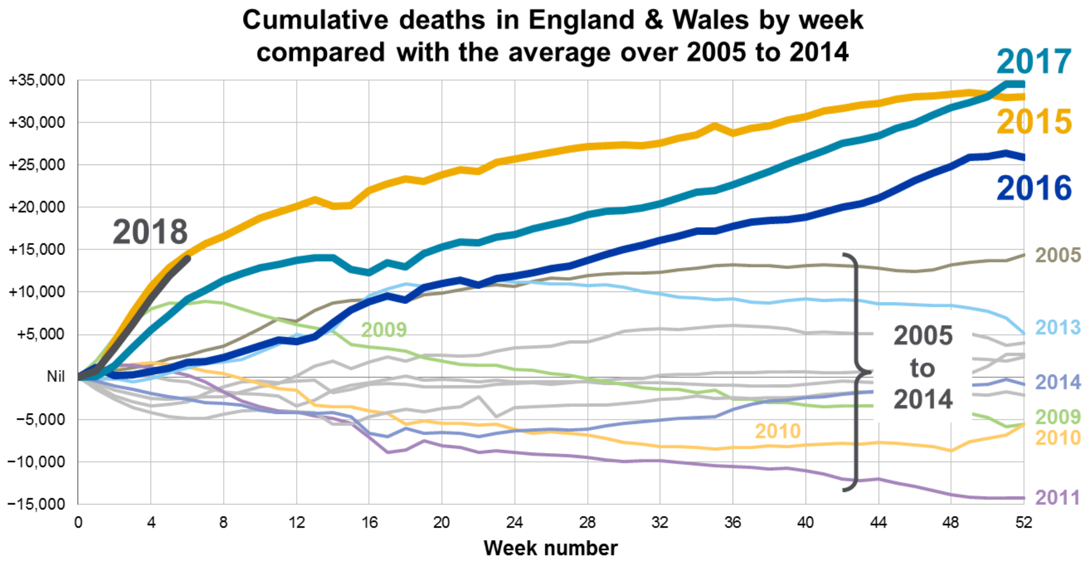
This structure minimised the additional contribution required from the sponsor, while at the same time offering flexibility and choice to members; it also enabled the trustees to ‘lock into’ favourable bulk annuity terms as early as possible.

The sponsor and trustees were able to settle the scheme liabilities in full with their preferred counterparty for an acceptable price. Eligible members were offered flexibility in the form of their pension benefits; and benefit security was attained for members.

Registered Deaths for 2017 Exceed Previous Levels

In our November Risk Settlement Bulletin, we highlighted the uncertainties surrounding mortality over the final couple of months of 2017 and how these might feed through into the next mortality projections model, CMI_2017, expected to be released by the Continuous Mortality Investigation in March.

The number of deaths is only one part of assessing mortality; the change in the age and size of the population also needs to be considered. After allowing for population changes, we find that there was a small improvement in mortality in England & Wales over 2017, continuing the slower improvement trend that has been seen over recent years (0.8% per year for males 2011 to 2017, compared to 3.1% per year over 2000 to 2011).



Weekly death registration information for England and Wales released by the Office for National Statistics indicates that c525,000 deaths were registered in 2017 – higher than the number of deaths registered in 2015 (c521,000) and 2016 (c517,000). See the above chart.

Cumulative deaths in 2017 overtook those in 2015 only in the last two weeks of December, at a time when it was reported that the NHS was under its greatest strain. This excess mortality towards the end of 2017 was partially attributed to the 'flu – a high level of incidence of the H3N2 strain of influenza had been expected following the experience of Australia during their 'flu season. 2017/18 has been a relatively heavy 'flu season for England & Wales. The GP consultation rate for influenza-like illness increased significantly over the flu season, from 11.4 per 100,000 lives in mid-December to a peak of 53.1 per 100,000 in mid-January before decreasing. As a result, over 3,000 deaths were attributed to respiratory disease in the second week of 2018, which is higher than any week since early 2015.

We have updated our estimate of CMI_2017 to reflect the complete year of death registrations in 2017. Assuming typical (and unchanging) user-defined parameters and that the CMI does not revise its modelling approach, we anticipate that life expectancies using the new model will again be lower than the previous model, CMI_2016, with reductions in life expectancy of 0.5% to 1% (depending on age).

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