Risk Settlement Market 2019

Empower Results®

Introduction
A record year, with more to come

As widely predicted, 2018 was a record year for the bulk annuity market. The continuation of strong bulk annuity pricing across the market, driven by increased appetite and continued innovation from insurers, led to £30Bn of risk being transferred over the year.

From Aon's perspective, we were able to capitalise on these conditions to achieve the best results possible for scheme members across over 20 deals ranging from £2m to £1.5Bn. Within the review, we have included an in-depth look at the PA Consulting case study where we achieved an outcome which far exceeded the scheme's expectations through a combination of the full range of liability management exercises.

The majority of press coverage during 2018 was devoted to the increasing number of £Bn-plus deals that were completed, and we examine how preparation and timing for these deals is crucial for securing the best price. However, there was lots of activity in other segments of the market – and particularly for bulk annuity transactions below £30m, where we observed varying appetites from insurers, with attractive pricing achieved for transactions of this size from many providers. You will read in more detail the ways this might enhance the opportunities available for schemes who are concerned about being squeezed out of the market.

Other highlights of the articles that are covered include reviewing your long-term strategies, looking at the latest trends in longevity and the growing importance of dependant modelling. We also look at what the future holds with the emergence of commercial consolidators and increasing use of technology. We close with a review of what is happening in the overseas markets where other countries are starting to catch up with the UK in focusing on and managing pension risk.

The first part of 2019 has continued where 2018 left off, with a number of multi-billion pound deals entering the market, including the Rolls-Royce UK Pension Fund, who completed a partial buyout in excess of £4.6Bn. This is the largest ever UK buyout, for which Aon was lead advisor of the trustees. We also saw a continued flow of buy-in and buyout deals in the smaller and mid-market range, and we are seeing increased interest in longevity hedging as the market continues to adapt to the new environment of lower mortality improvements.

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Preparation is key to avoid disappointment.

With rising demand, and the number of mega-deals expected to reach an all-time high in 2019, insurers are able to be more selective about the schemes that they choose to price.

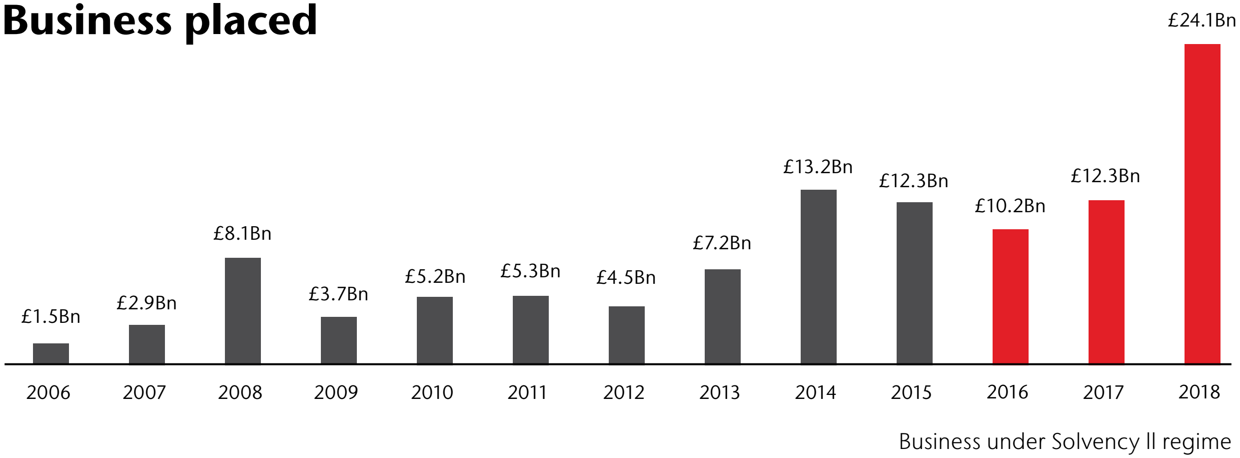
Insurers will continue to focus their resources on transaction-ready schemes, particularly at the smaller end of the market, and so a clear de-risking objective and thorough preparation will be key in order to attract the very best pricing available.

I hope you enjoy reading the selection of articles and that they provide food for thought. Do get in touch with me or one of the team if you would like to talk in more detail about opportunities for your own scheme.

2018 in review

At the start of 2018 we expected a record-breaking year for the bulk annuity market. We predicted over £30Bn of risk settlement activity and the market delivered, with over £35Bn of business being placed.

Business placed



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The key factors driving this bumper year were:

- Exceptional pricing in the market, driven by better illiquid asset sourcing capabilities and competition;
- Strong capacity from the global reinsurance market, which acts as a key support to capacity in the annuity market;
- Improved scheme funding, with more schemes finding themselves within touching distance of settling their liabilities.

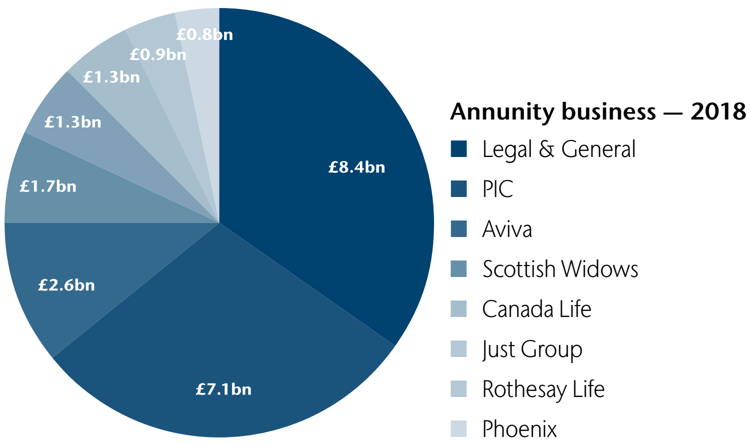
This restored the long-term growth pattern of bulk annuities, following interruptions from the credit crunch (2008) and transition to the tougher Solvency II regulatory regime (2015-16).

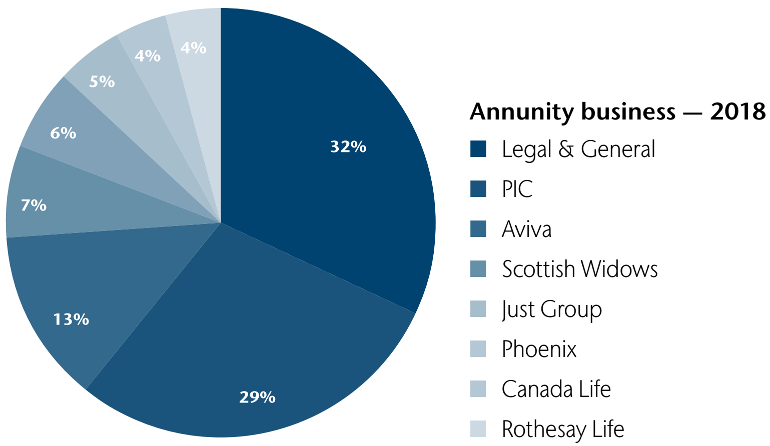
But it was not just the total market that broke records in 2018:

- PIC, Legal & General, Aviva, Scottish Widows and Canada Life all wrote their largest volume of bulk annuities to date;
- Six of the eight insurers wrote their largest external deal to date, some several times over;
- Phoenix Life wrote their first external bulk annuities as they continued to grow their capabilities.

With all eight insurers now firmly established, pricing is expected to remain competitive.

There was also a new record deal size in the back-book market, with Rothesay Life surprisingly taking on the whole of a £12Bn tranche of annuities from Prudential, who had permanently pulled out of the annuity market.





Except for specialists PIC and Rothesay Life, these insurers also make up almost all of the remaining individual annuity market.

2018's bulk annuities were dominated by large transactions – Legal & General secured the largest ever annuity for a pension scheme (£4.4Bn with British Airways) and three more £1Bn+ annuities were placed with PIC and Legal & General. This led to a temporary shortage of asset opportunities to back new deals, in the autumn.

Size	Insurer	Business	Type
£4,400m	L&G	BA	Pensioner annuity
£2,400m	L&G	Nortel	Full scheme annuity
£2,000m	Zurich	National Grid	Longevity swap
£1,515m	PIC	Rentokil	Full scheme annuity
£1,300m	PIC	Siemens	Pensioner annuity
£925m	Aviva	M&S	Pensioner annuity
£880m	SW	Littlewoods	Pensioner annuity
£850m	PIC	PA Consulting	Full scheme annuity
£770m	PIC	BHS	Full scheme annuity

The Aon settlement team were lead adviser on 16 transactions of over £100m in 2018 (another record!). Key to our rate of conversion is advance preparation, close monitoring of the market and flexibility over the timing and manner of deal completion.

There is still a market for smaller transactions. Four insurers are routinely writing transactions below £100m, with some attracting pricing that is surprisingly similar to that attained by the largest cases. In order to help more schemes access the market, Aon has worked with insurers to develop our new 'Streamlined Compass' approach for smaller transactions, designed to maximise insurer engagement and deliver the best possible pricing.

So we turn to 2019 and the market shows no sign of slowing down, with Aon predicting another year where risk settlement activity tops the £30Bn barrier. Pricing remains competitive.

The first quarter – normally a comparatively quiet period – has seen several large new transactions, with those for the Co-op, Pearson and Société Générale already in the public domain, and a large number of auctions due to close by the autumn including several £1Bn+ full scheme buyouts.

A busy market is not without its challenges. Insurers are particularly selective over auctions in 2019, favouring the best-prepared schemes.

Aon Risk Settlement Team 2018 highlights

26
bulk annuity transactions completed in 2018

c30%
of total market volume advised by Aon in 2018

16
bulk annuity transactions of £100m or over during 2018

£11Bn
liabilities secured in 2018

8
transactions with 8 active insurers over 2018

Recognised excellence

PROFESSIONAL PENSIONS UK PENSIONS AWARDS 2018 WINNER Risk Reduction Adviser of the Year

Pensions Expert PENSION AND INVESTMENT PROVIDER AWARDS 2018 Winner DERISKING CONSULTANT Aon

European Pensions AWARDS 2018 WINNER Risk Management Firm of the Year

Lead adviser to schemes completing £100m+ transactions in 2018
(*based on disclosed data – typically only published for larger deals)

Lead Advisor	Schemes advised
Aon	17
LCP*	10
Mercer*	5
KPMG*	3
Willis Towers Watson*	3
Hymans Robertson*	2
PWC*	2
Other transactions*	3

Lead adviser to Schemes carrying out over £500m transactions since 1 January 2014
(*based on disclosed data)

Lead Advisor	Schemes advised
Aon	11
LCP	8
Mercer	3
PWC	2
Barnett Waddingham	1
KPMG	1
Undisclosed	2

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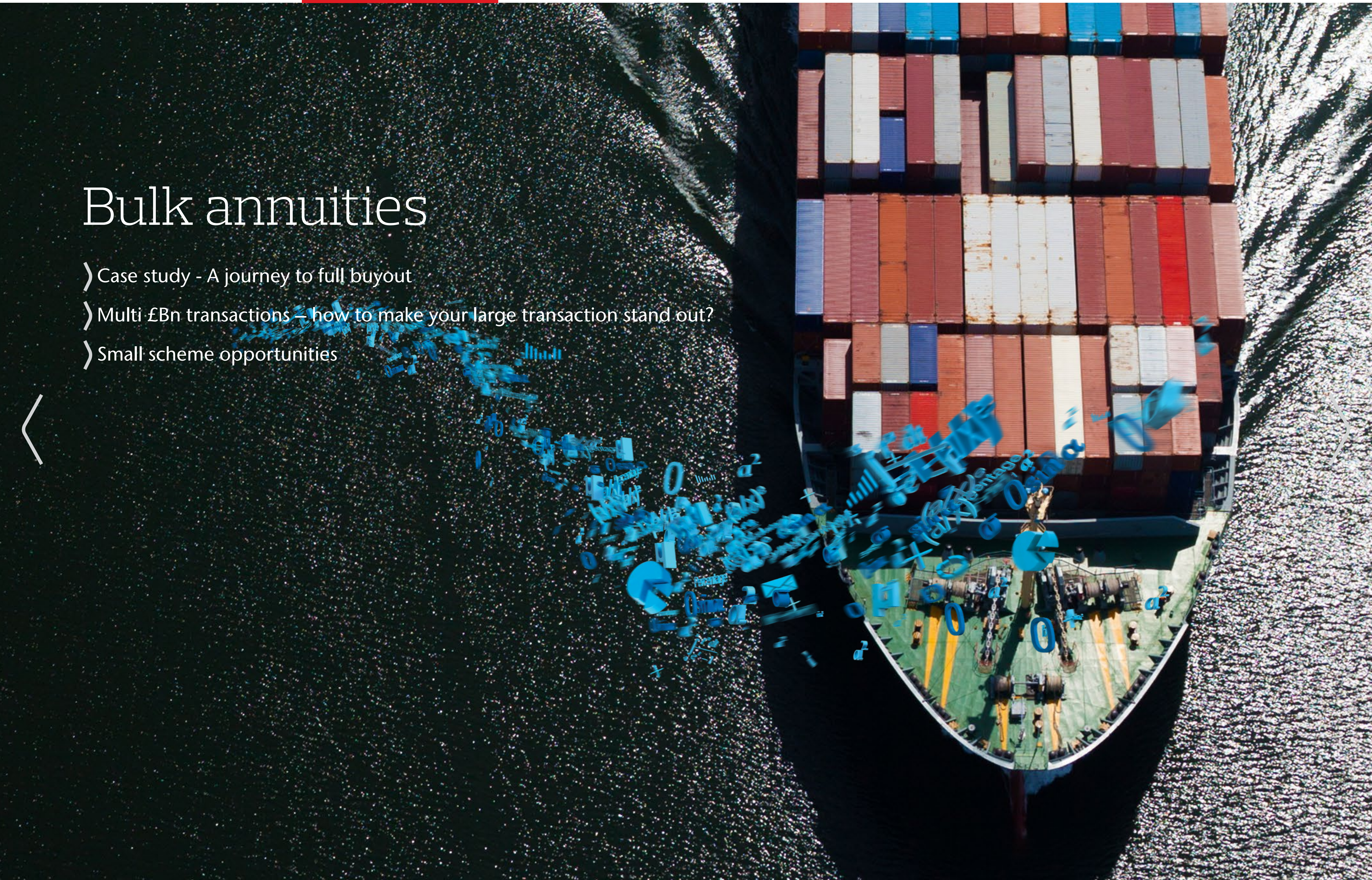

Bulk annuities

Bulk annuity case study

PA Consulting

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"Buyout was something we never thought was possible two years ago when we appointed Aon. Kudos to you for raising this in the first place; and then sticking to your guns to convince a demanding Trustee and Company that it was the right path!"

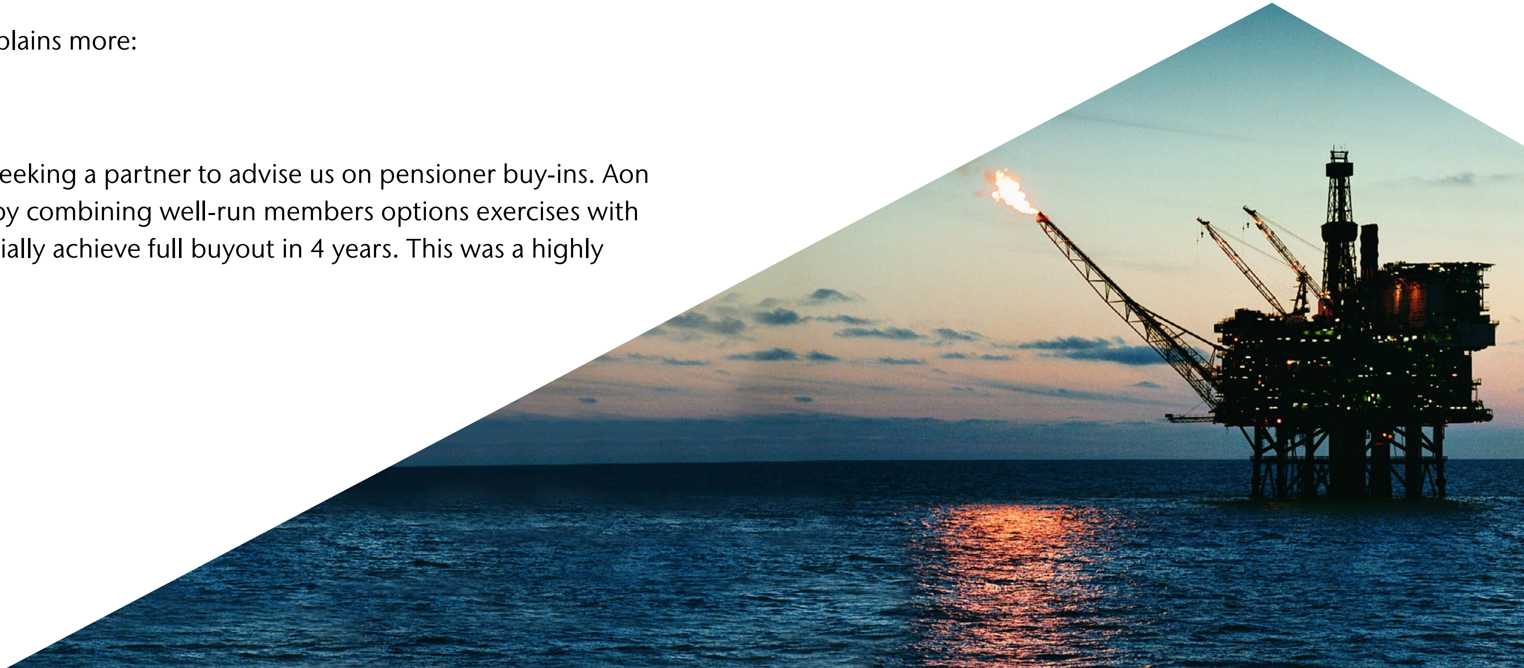
Daniel Baker, Pensions Manager, PA Consulting

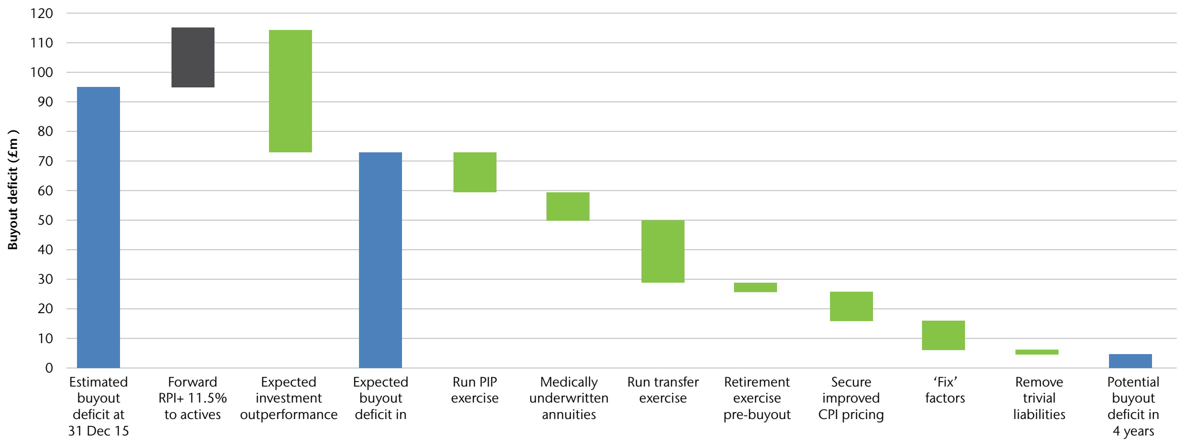
In 2016 Aon was appointed to act as a specialist adviser to help de-risk PA Consulting's pension scheme. Over the following two years, Aon advised on member options and was the sole lead adviser to a highly innovative £850m buyout which was so attractively priced that no additional contribution was required from the sponsor.

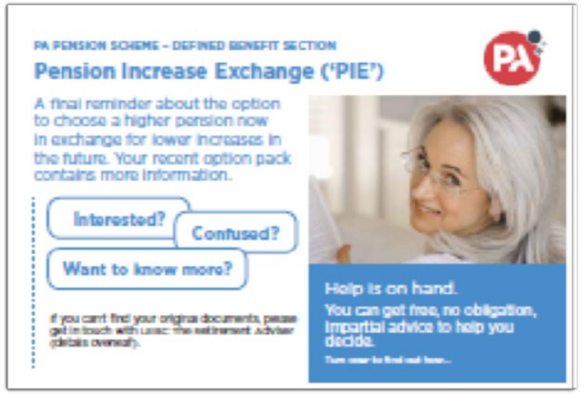
Daniel Baker, Pensions Manager PA Consulting, explains more:

How did PA's journey begin?

"Our scheme was relatively mature and we were seeking a partner to advise us on pensioner buy-ins. Aon provided a fresh perspective demonstrating that by combining well-run members options exercises with heavily negotiated bulk annuities we could potentially achieve full buyout in 4 years. This was a highly attractive scenario to the sponsor."







Which steps did you complete first?

"Our journey began with a Pension Increase Exchange exercise. Members had the opportunity to exchange inflation-linked pensions for a higher flat rate pension – a favourable benefit shape for many individuals. 41% of members accepted, demonstrating the attractiveness of offering flexibility to members and helping the scheme to reduce the buyout deficit by c£15m.

This take-up rate was well above market norms and is a testament to Aon's clear communications provided to members, ensuring they could understand and engage with the offer."

What about transfer values?

“Initially we weren’t sure whether our members would be interested in transferring benefits out of the security of the scheme. As we understood the potential benefits for some individuals, we gave members the option to transfer out of the scheme at an enhanced rate and provided paid-for independent financial advice to help members make an informed decision. With the buyout negotiations running in parallel, all the communications were drafted to ensure clarity on the impact the buyout would have on members’ benefits, and also on the enhanced transfer value offer.

The six-month exercise was well received, with in excess of £110m of transfer values being paid to UK and overseas members of the scheme. This represents a 33% take-up rate, significantly above recent market levels and also our expectations.”

What made the buyout a success?

“Our transaction began with a meeting between our joint working group and insurers. The aim was to ensure insurers fully understood the commitment of all parties to buyout, the proposed transaction structure and the extensive data and benefits preparatory work already completed.

“That preparation and the initial meeting paid dividends with insurers committing to prioritise the scheme as a highly attractive part of their 2018 transaction pipeline.

Governance was also key — by putting in place a nimble framework, we were able to move at pace when we realised the market conditions and insurer appetite were able to deliver pricing beyond our expectations.

Aon negotiated with insurers on behalf of the joint working group, delivering an innovative transaction. All non-standard benefits were replicated and we maintained members’ ability to aggregate their defined benefit and defined contribution benefits at retirement.”

How did you integrate the two worksteams?

“To optimise the risk reduction, Aon asked insurers to complete the bulk annuity transaction while the Enhanced Transfer Value exercise was in progress. This unique and innovative solution was negotiated whereby the bulk annuity contract was signed prior to the completion of the ETV exercise allowing earlier de-risking for the scheme and capturing favourable insurer pricing.

“Of course, none of this would have been possible if the price didn’t work for us. It wasn’t just achieved by the robust negotiation that Aon carried out, but by their ability to seek out pricing opportunities in a competitive market and to lock down that price as quickly as possible.”

What advice would you give to others considering this journey?

“Do everything you can to be a credible counterparty to the insurer and prepare well ahead of time for the information insurers will need. Review and correct your data, document your rules, review the trustee’s policies on discretions, and review your administration processes over the life of the scheme.”

In 2019 and beyond we see increased appetite from sponsors and trustees to secure members’ benefits in full. By combining member options and bulk annuities this can be done in a cost-efficient way delivering optimal solutions for all.

Multi £Bn transactions – how to make your large transaction stand out

Multi-billion pound transactions demand the most insurer resources. This is due to the need for their pricing teams to model multiple benefit categories, reinsurance teams to source pricing from multiple counterparties, investment teams to design and source bespoke pricing portfolios and additional governance requirements, where full board approval will be needed.

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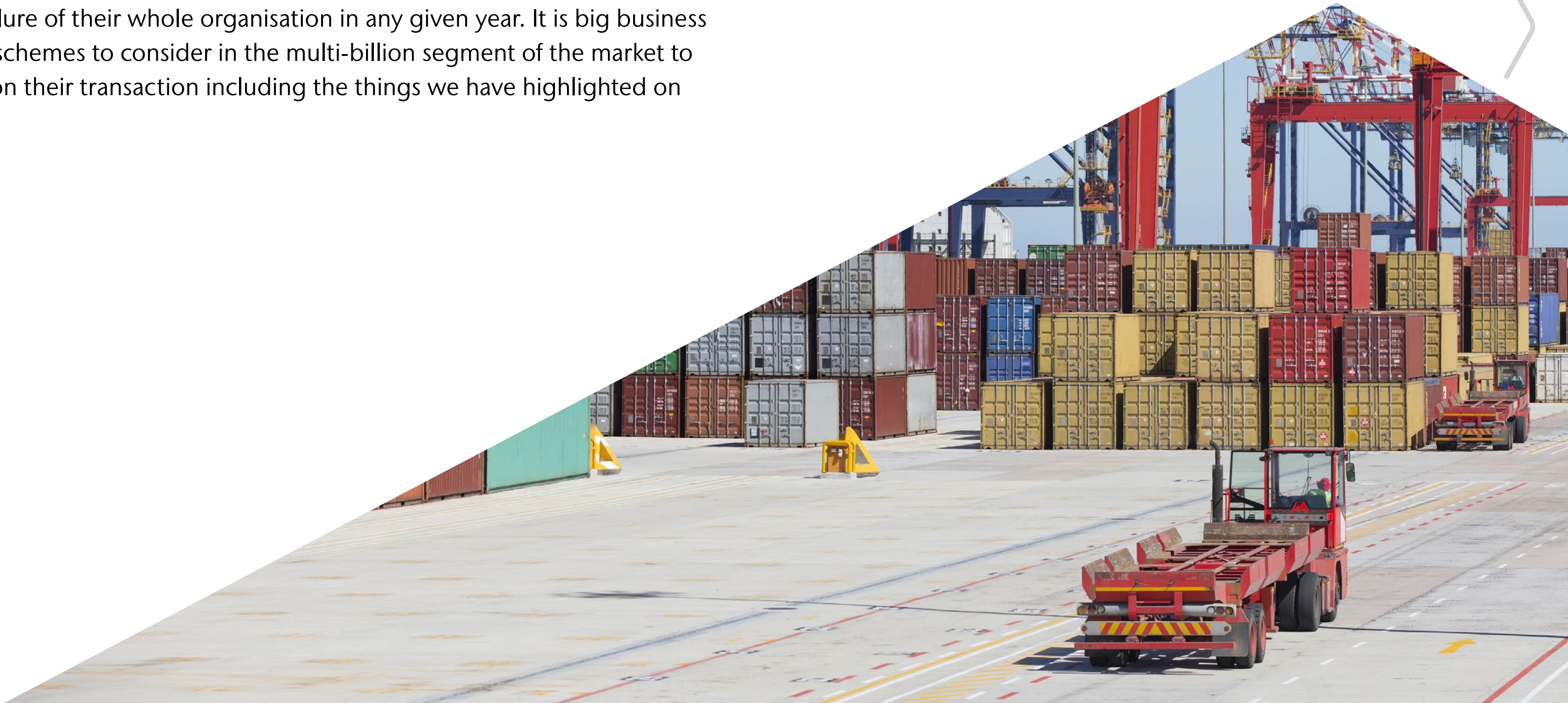
All of this means that insurers are faced with placing 'big bets' from a resource perspective on large deals where outcomes are binary – a transaction happening or not and them winning or not can make the difference to the success or failure of their whole organisation in any given year. It is big business and there are different factors for schemes to consider in the multi-billion segment of the market to ensure insurers place the big bet on their transaction including the things we have highlighted on the next page.



Premium payment portfolio

For any transaction, insurers need to consider the 'day 1' capital requirement, ie, what capital do they need to allocate from the outset. This will determine pricing but also their appetite for a transaction as they look to allocate their capital across a total new business target.

The capital requirement for a specific transaction depends on many factors, not least the assets that will be held by the insurer, and while they may transition to an optimal portfolio over time, on inception these assets will be made up of:

a. Assets the insurer has sourced ahead of transacting; and

b. Assets transferred as premium payment

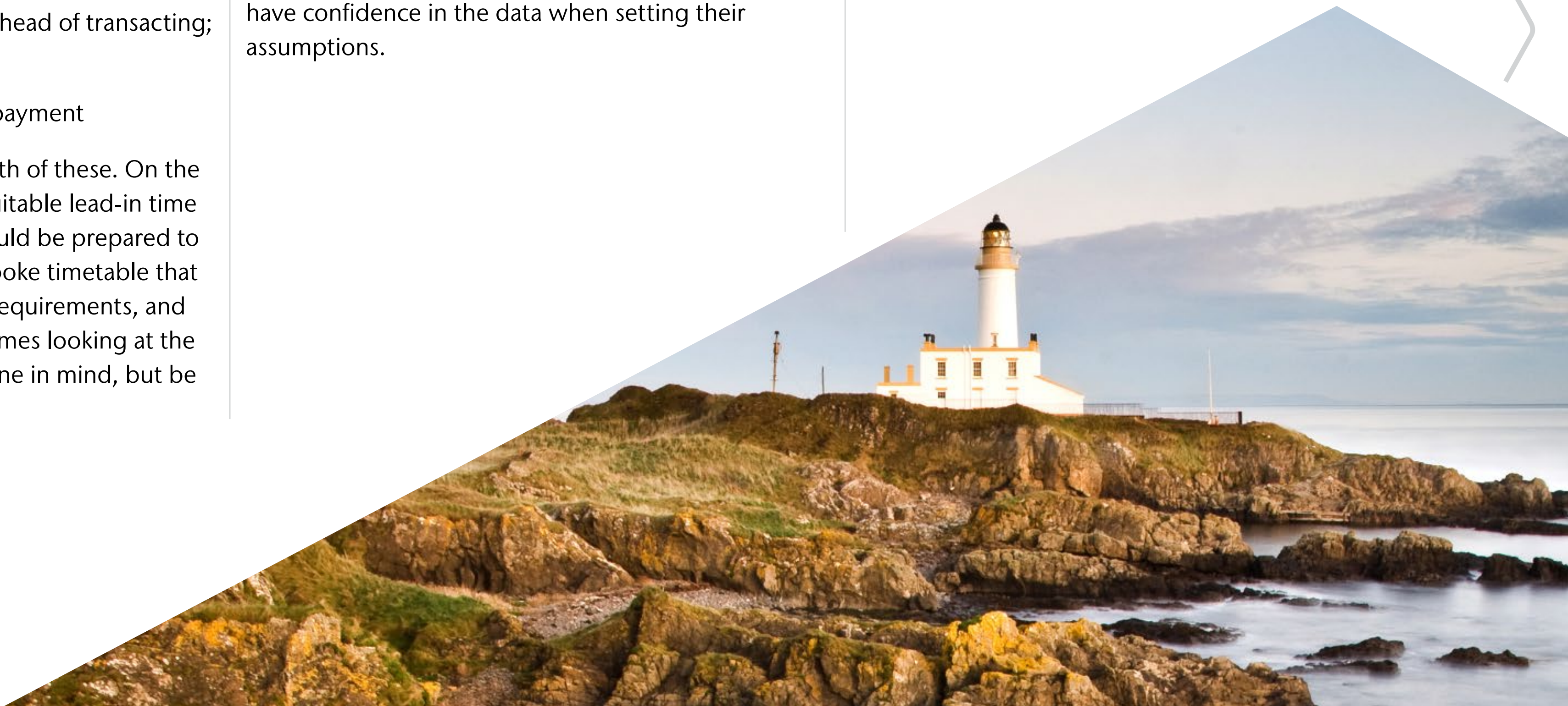
Pension schemes can influence both of these. On the first, it is important to provide a suitable lead-in time for a transaction and schemes should be prepared to work with insurers to agree a bespoke timetable that enables them to optimise capital requirements, and therefore pricing. Essentially, schemes looking at the largest deals need to have a timeline in mind, but be prepared to be flexible.

Longevity risk underwriting

Insurers and reinsurers look at mortality experience data in a different way to scheme actuaries. They only get one opportunity to assess the underlying risk and price it. As such, for large transactions, where mortality experience analysis is likely to be a key pricing driver, focussing on the quality of the experience data ahead of going to market (alongside data for the members to be insured) can make a significant difference. This should include a reconciliation of death numbers against prior year accounts as well as identifying gaps in data or duplicate records to ensure that providers have confidence in the data when setting their assumptions.

Governance

Given an increased focus from insurers on transaction certainty for large deals, it is critical that schemes can articulate clear transaction governance. This means explaining which decisions have already been made (eg, on transaction structuring) and when and where future decisions will be made. Importantly, this extends to both trustee and employer governance, where there is awareness among insurers that the largest deals will typically require board level sign-off at employers. The importance of putting in place appropriate governance should never be overlooked.



Small scheme opportunities

There has been a recent focus by the bulk annuity market on larger transactions, with the market showing increased capacity since 2017. These deals may get more focus from insurers and from the press, but there remain significant opportunities for all schemes.

There are often misconceptions over insurer appetite at this level of transaction (and the pricing on offer). With the right preparation and strategy for approaching the market, positive outcomes are achievable.

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2018 experience

Pricing observed in 2018 was very attractive relative to the yields available on other low risk assets, and this pricing was often just as favourable for deals below £30m, where the auction was appropriately planned. This might be surprising, but insurers like smaller transactions because:

- There tends to be a steady flow of these (in contrast to a 'lumpy' flow of potential deals more than £1Bn in size), which makes it easier to plan resource;
- There is usually a greater probability of success for an insurer (often these deals have fewer bidders), provided affordability has been considered appropriately at the feasibility stage of the project; and

These can be written with relatively low senior management involvement from the insurer, with confidence in the price. The table below shows those insurers with more consistent appetite for quoting on transactions under £30m in value.

Provider	Quote on sub-£30M cases?	Comments (as at Janaury 2019)
Aviva	✓✓✓	Active in this market, appetite for buy-outs will require data cleanse work up front for some cases
Just	✓✓✓	Keen to provide quotations; focus on pensioner deals and would look to standardise process where possible
Canada Life	✓✓	Active in this market but will not quote on every case due to available resources; focused on pensioner deals
Legal & General	✓✓	Considering re-entering this section of the market in 2019 but will be selective
PIC	?	Appetite will depend on other deals closing at this time

Being 'transaction ready

Insurers will favour the best prepared schemes where there is greater certainty of transaction.

Carrying out preparatory work advance of going to market is important. This includes having a clear decision-making framework to be able to execute quickly once a price threshold is achieved.

Aon's solution

Aon's new Streamlined Compass proposition is an additional option, designed to help sub-£30m schemes access the bulk annuity market. To develop this, we have worked directly with insurers to design a simplified approach. This includes advanced planning with insurers, cleaner data, built-in due diligence, and streamlined annuity contracts. Maximising insurer engagement will deliver the best possible pricing.

Long-term strategies

- Expanding the use of technology
- Annuities vs alternative long-term strategies
- De-risking strategies for financial sector clients
- Consolidators

Expanding the use of technology

According to Heraclitus ‘Change is the only constant in life’. Technology is often a major source of that (constant) change in current times! The settlement market is no different, with technology and data leading to evolutions in the way we work with both schemes and insurers.

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Increased demands on time

The pace of modern life tends to be more demanding, with individuals juggling a number of commitments and responses or decisions being needed quicker than ever. To respond to this, we have expanded the ways in which we provide information to schemes. Email updates can be replaced by podcasts, and a library of content is available through our Risk Settlement App for those preferring to dip into topics when they have some free time. For those not able to make face-to-face meetings, advances in webex and video conferencing have gone a long way to bridging the gap. Online bitesize training videos can also help fill in any knowledge gaps before the next meeting.

Tools for quicker decision making

With decision makers’ time at a premium, it is important to be able to develop supporting analysis interactively in meetings, rather than having to go back to the office to further discussions. We have a suite of interactive tools available which assist decision making, where relevant.

At a more basic level, available data feeds allow us to track pricing opportunities and transact when the agreed metrics are met.

Where next?

It will be interesting to see how far technology advances go within trustee decision making, and the settlement market as a whole. Will we ever got to a position where a trustee or insurer would feel comfortable sending a text to proceed with a transaction?

Annuities vs alternative long-term strategies

Can a clear annuity strategy help achieve your long-term funding target?

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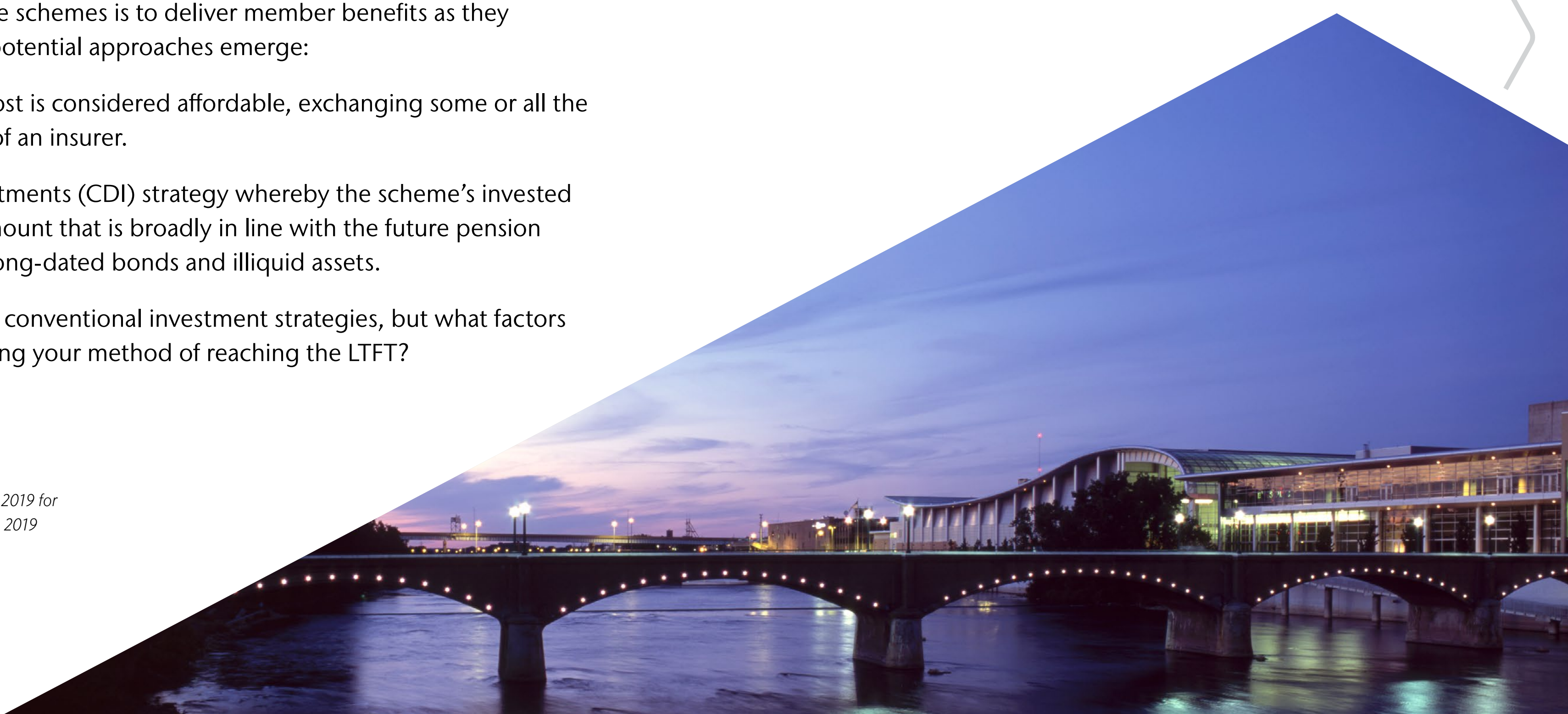
Maturing pension schemes will have a clear idea of how they pay each pensioner month-by-month, but managing this commitment over the next 40+ years is not straightforward. The Pensions Regulator continues to highlight the importance of focusing on this primary objective, with the latest expectation being for all schemes to commit to a long-term funding target (LTFT)* and take steps to achieve it.

When the primary focus for mature schemes is to deliver member benefits as they become payable, two long-term potential approaches emerge:

- Purchase annuities when the cost is considered affordable, exchanging some or all the scheme risks for the covenant of an insurer.
- Adopt a Cashflow Driven Investments (CDI) strategy whereby the scheme's invested assets pay out at a time and amount that is broadly in line with the future pension payments – typically a mix of long-dated bonds and illiquid assets.

Both are valid, as are several other conventional investment strategies, but what factors should you consider before finalising your method of reaching the LTFT?



* *The Pensions Regulator, Annual funding statement 2019 for defined benefit pension schemes, published March 2019*

Investment return

CDI can target a higher yield than annuities by investing in illiquid assets or long-dated corporate bonds, but the offsetting costs of managing the increased risk this introduces will need to be considered. Pensioner annuities at current pricing can lock in an implied return of c50 bps. above gilt yields, which may be affordable for many long-term objectives.

Volatility

Annuities are often seen as a 'super-matching' bond which is directly linked to the pension members will receive and is the only way to completely remove all interest rate and inflation risks. Mature schemes managing their own investments will look to hedge the most significant financial risks but will continue to bear the potential downside of unlikely events (e.g, periods of prolonged deflation) over the lifetime of the scheme.

Longevity risk

Longevity risk is significant when measured over the lifetime of the scheme and can be addressed either through insurance (annuities or a longevity swap) or self-insurance (i.e, holding additional reserves as a buffer if members were to live longer than assumed). Many schemes, particularly those smaller than £500m, will conclude that sourcing their own longevity protection is expensive in the current market and so will leverage an insurer's ability to provide this cover cheaper via an annuity. Larger schemes have more options, but many will still seek to hedge longevity risk to manage their overall risk profile.

Covenant

Aiming to deliver a LTFT using CDI or other managed asset strategies requires a long-term reliance on the sponsor covenant to support the scheme if risks are not suitably hedged. Gradually securing risk through phased annuities will reduce this reliance on the sponsor over time.

Governance

After a one-off broking exercise, annuities are a relatively low burden over the long-term, subject to having reasonable administration processes in place. This differs to most other investment strategies that require regular monitoring and rebalancing to maintain the desired risk protection.

Sponsor considerations

Annuities can have a variety of impacts on a sponsor's corporate accounts, depending on the accounting regime and type of insurance purchased. Annuities are likely to be required to release the sponsor from legacy pension obligations and so are often considered as part of a wider pensions strategy, not just as a tool to manage investment risk.

Flexibility

In most scenarios, an annuity policy is irreversible and cannot be exchanged at some later date. Should the scheme want to re-risk and target a greater investment return they would need to use the other assets in the portfolio.

De-risking strategies for financial sector clients

Financial sector schemes led the market in asset de-risking in the early 2010s. Over the last 18 months, many of our financial sector clients have been turning their attention to addressing longevity risk, which is now their largest remaining pension risk.

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Financial sector scheme members

When considering insurance solutions, the specifics of the population to be insured need be carefully considered.

- Large retail banks can have split populations with very different mortality expectations. For example, many members who worked in bank branches as well as members with high pensions who were involved in financial trading. Using a whole scheme mortality benchmark would not be appropriate when insuring a subset of the population.
- The membership of schemes sponsored by investment banks are typically very skewed towards members in affluent socio-economic groups which tend to be more insulated from recent drivers of heavier than expected deaths. This needs to be considered when assessing the value of insurance pricing.

Impact of banking capital on decision making

For those financial sector clients regulated by the Prudential Regulatory Authority (PRA), the regulatory capital impact can help to determine which insurance solution is appropriate for a scheme.

- Regulatory capital is driven by the accounting balance sheet.
- Under IAS19, longevity swaps have no day one balance sheet impact which makes them a particularly attractive solution for large PRA-regulated banks.
- This is not exclusive though; if the scheme is in a large accounting surplus some clients are content to use this to fund the purchase of a bulk annuity, as demonstrated by the case study.

Case study

In late 2018, Aon advised the trustees of the Bank of America Merrill Lynch UK Pension Plan on a £400 million pensioner buy-in with Scottish Widows. We advised the plan throughout the transaction using our market-leading Bulk Annuity Compass platform which enabled the plan to move quickly at a time when pricing was attractive.

"This transaction allowed us to continue our programme of de-risking by securing a bulk annuity for pensioner members on favourable terms, which has led to an improvement in the funding position on the plan's long-term funding basis. We are delighted with the advice and support provided by Aon."

Peter Gibbs, Chairman of Trustees for the Bank of America Merrill Lynch UK Pension Plan.

Choosing an insurer for your £1Bn+ transaction

In recent years, as both pricing and funding levels have improved for UK pension schemes, we have seen increasing appetite for larger buy-in and buyout transactions. Since the implementation of Solvency II, there have been seven £1Bn+ bulk annuity transactions, with many more in the pipeline.

Bespoke structuring and sourcing of assets is required on larger £1Bn+ transactions, given the limited availability assets and reinsurance requirements. As such, there are additional considerations in relation to insurer selection on transactions of this size.

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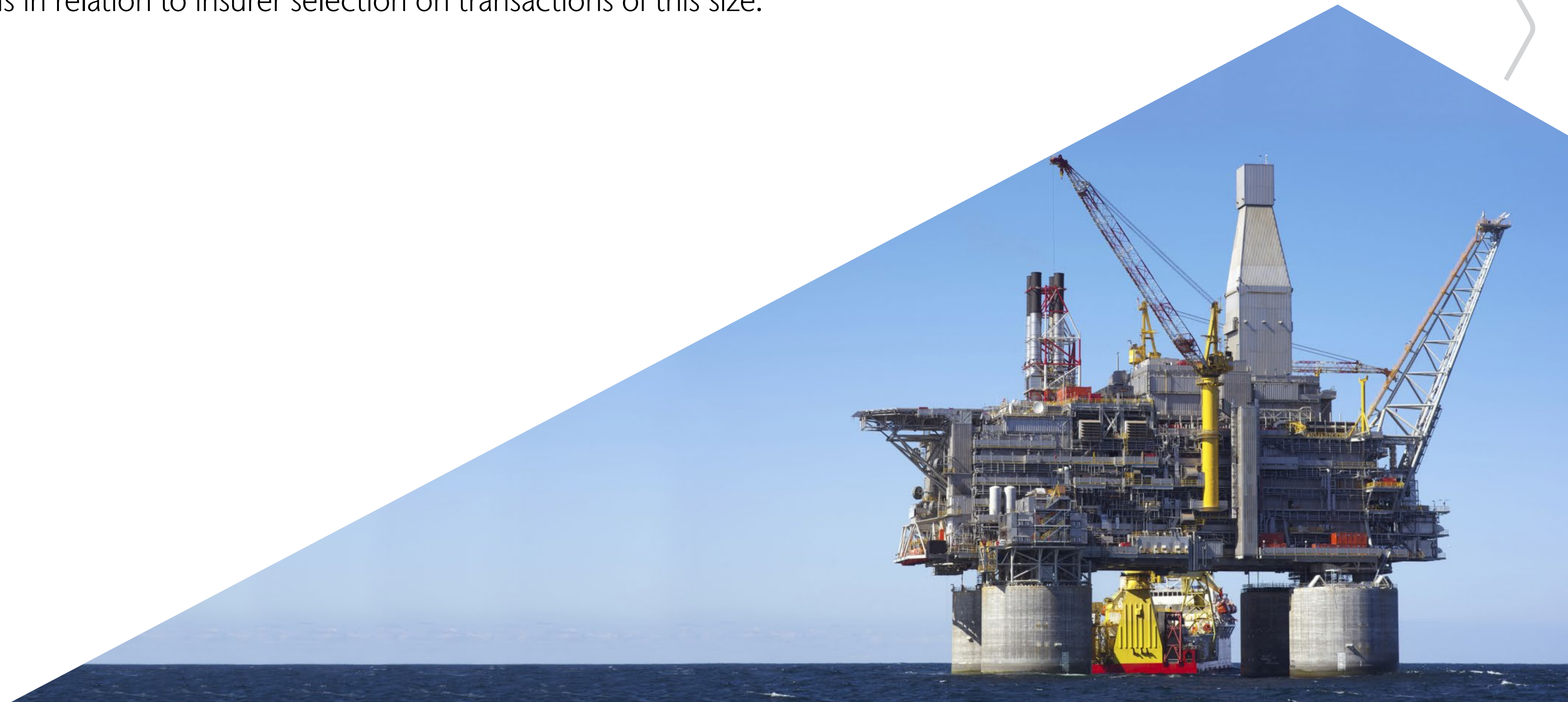

1. Ability to source capital

Understanding the insurers' ability and appetite to (a) source specific assets to match your liability profile (which in some cases may include raising additional capital from shareholders) and (b) take on existing pension scheme assets as part of the premium payment will be a key consideration in determining which insurers to engage with. Further, sourcing assets can take time, so it is also important to understand insurer timescales and any requirements around this.

2. Ability to access attractive reinsurance terms

For larger transactions, insurers will rely on the use of longevity reinsurance to underwrite some or all of a transaction. Therefore, understanding the insurers' ability to obtain the optimal reinsurance terms will also be an important consideration. In some cases, it may be preferable to source the longevity reinsurance directly and 'plug in' to the insurer annuity price to ensure the optimal reinsurance price is aligned with the optimal insurer price.

3. Use of multiple insurers

It may also be possible to optimise pricing by segmenting your liability profile, insuring different parts of the risk profile with different insurers. This can enable you to benefit from different pricing 'sweet spots' with different insurers and can increase the number of insurers quoting on the transaction. This does need to be done in a structured way, minimising the number of pricing permutations, to ensure insurer engagement is not compromised.

In our experience, it is important to develop a clear insurer selection strategy, considering asset sourcing, reinsurance approach and placement strategy upfront, to ensure success in the market on £1Bn+ transactions.

Aon has advised on 4 out of 7 £1Bn+ transactions since the implementation of Solvency II

Commercial consolidators

2018 saw the re-emergence of the concept of a 'commercial consolidator' – a company sitting outside the insurance world, whose primary purpose is to take on and run occupational DB schemes. While there have been several previous attempts to set up a similar vehicle, the DWP's March 2018 white paper on protecting defined benefit schemes (which promised a consultation on the regulation of commercial consolidators) gave new weight and standing to this idea. Following the white paper two consolidators – Clara-Pensions and The Pensions Superfund (PSF) — publically announced their offering.

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Impact on the bulk annuity market

Commercial consolidators offer an alternative ‘off balance sheet’ solution to the pensions problem, therefore creating a source of potential competition for the buyout market.

In practice, the overlap in the potential target market of consolidators and insurers is likely to be limited – the DWP's recent consultation proposed a 'gateway' test, discouraging trustees from agreeing to a transfer to a commercial consolidator if their scheme is expected to reach buyout funding within around five years. Although the nature and rigour of the regulations that will apply to consolidators is currently unknown, pending the outcome of the consultation, two things seem likely:

1. The security offered by consolidators is not expected to match the 'gold standard' offered by insurers – there is no political desire to force a closing of this gap;

2. Trustees are likely to be considerably more nervous about consolidator entry than buyout.

In the short term at least, it seems likely that buyout will remain the preferred choice for trustees, where achievable.

However, even if consolidators and insurers are not typically competing for the same schemes at the same time, we can expect to see some reaction from the insurance market. Increased innovation is one possible result, with insurers seeking to find solutions to help schemes reach full buyout. Insurers may choose to set up their own consolidators, or to launch alternative products to provide another option – L&G's relaunch of their Insured Self Sufficiency product is an early example. We may also speculate that – should consolidators start to gain traction with schemes – insurers will feel pressure to keep bulk annuity pricing close to the current attractive levels to keep their own potential share of the market as large as possible – perhaps counteracting the impact of demand outstripping supply over 2019 and beyond.

Whether or not trustees and sponsors see consolidators as an attractive end game for their own schemes, the increase in options available, and the innovation and efficiency that this is expected to bring, should certainly be welcomed.

Longevity and demographic risk

Longevity market review

2018 was a fairly active year for UK pension schemes targeting their demographic risk exposure, while retaining investment control and freedom, through longevity swaps. This followed the market's resurgent 2017, during which the prior year's total deal volumes was almost tripled.

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The headline transaction was the £2Bn deal we structured between National Grid's electricity pension scheme (part of the electricity industry-wide ESPS umbrella arrangement) and Zurich, with at least two other schemes also entering into longevity swaps, and other transactions progressing towards execution in 2019.

We cover the National Grid transaction in detail on page 34.

Alongside the various 2017 transactions, this deal demonstrated that the full range of 'intermediation' options remain on the table, and attractive to different pension schemes depending on their specific objectives and perspectives – including their size, availability of expertise and resource for ongoing governance and oversight, appetite for risk and operational complexity.

Longevity swap intermediation at a glance

The primary capacity for taking on UK pension scheme longevity risk is in the global reinsurance market. But pension schemes are not legally able to enter into reinsurance contracts.

An 'intermediary' insurance entity sits in the middle, to 'transform' the reinsurance capacity into an insurance contract, and to service the transaction on an ongoing basis – taking responsibility for data flows, payment and collateral calculations, reporting etc.

There is a range of intermediation providers and models, with different costs, benefits and risks for schemes:

- The National Grid transaction was on a 'full intermediation' basis with the UK insurance arm of Zurich, with the scheme not facing any exposure to the credit risk of Canada Life Re who provided reinsurance to Zurich
- The Scottish Hydro-Electric longevity swap executed in 2017 was also with a UK insurer, with Legal & General providing a UK based insurance counterparty as well as being responsible for the ongoing servicing of the transaction on a day-to day basis, but this transaction was on a 'pass through' basis, under which the scheme takes on reinsurer credit risk
- Other recent deals – for example the 2017 British Airways transaction – involved the pension scheme setting up and running an 'offshore' insurance cell, through which the longevity reinsurance is accessed

But what of the longevity reinsurance market – is there attractively priced capacity to access through a scheme's chosen intermediation vehicle?

In short, yes.

There remain around a dozen global reinsurers with increasing appetite and deal capacity. But demand for longevity reinsurance from UK insurers continues to be very high, and reinsurers' pricing teams remain comparatively small. So, to maximise the market's engagement to drive the best deal, schemes need to:

- Be demonstrably well prepared – as with the bulk annuity market, this includes transaction clarity, clean data, and clear trustee and sponsor governance
- Be realistic and patient – demanding reinsurance pricing within a few weeks is likely to result in some reinsurers declining to participate in deals
- Be careful!

This final point warrants some explanation. Schemes' assessments of members' life expectancies have continued to change materially over a fairly short period of time, in particular as schemes have updated their analysis of their own experience as part of routine funding valuations and have adopted the latest version of the CMI longevity projection models. This has largely resulted in a reduction in life expectancy assumptions, reflecting heavier than expected death rates over recent years. As schemes continue to reflect the most up-to-date assumptions, this can mean 'stale' reinsurance pricing which looked good value a few months ago, may then appear less attractive. As was the case during the market's 'dislocation' in 2015-17, when reinsurance market pricing took some time to reflect the latest trends, schemes need to take care to avoid 'deal fever' and be prepared to pause and challenge whether pricing remains good value.

We have seen very attractive reinsurance pricing available during 2018 and early 2019, but it nevertheless remains important to keep a strong watching brief, particularly for projects which often run for many months before final execution.

Case study

National Grid – transaction at a glance

Deal size and scope:
c.£2Bn of pensioner and dependant liabilities covered relating to c.6,400 members

Counterparty:
Zurich UK was the scheme's sole counterparty, with most of the longevity risk being ceded by Zurich to Canada Life Re

Decision-making:
Early identification of key stakeholders and decision-makers, and creation of an effective working group led by the trustee and including the OFGEM-regulated sponsor working collaboratively with an advisory support base. Focus on key metrics, including critical value for money assessment reflecting both trustee and sponsor requirements

Intermediation structure:
Selection of full intermediation basis supported by broad quantitative and qualitative analysis. The decision reflected (a) minimal trustee and sponsor appetite for operational and structural complexity and risks, and (b) an assessment that the overall cost savings from other structures was relatively marginal

Structural terms:
The transaction was structured with a pragmatic approach to operational and collateral processes to minimise operational burden while ensuring robust longevity and counterparty credit risk protection. Additional future-proofing contractual provisions were included, in particular to facilitate effective annuitisation

Timing:
The transaction was paused in 2016 following Aon's observed 'price dislocation' within the longevity market. A re-pricing exercise in 2017 confirmed reinsurance pricing had 'relocated' to fair value, with the transaction ultimately executing in March 2018.

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Longevity issues in 2018

For those who monitor longevity trends closely, 2018 was a year of ‘more of the same’ – the slow rate of mortality improvements continued as it has since 2011, making it even clearer that this is a new trend, rather than a series of one-off ‘blips’ in mortality rates. This additional certainty over the new trend has been reflected in the latest version of the industry-standard mortality improvements model (‘CMI_2018’). What is still an open question is the extent to which improvements have fallen for pension scheme members.

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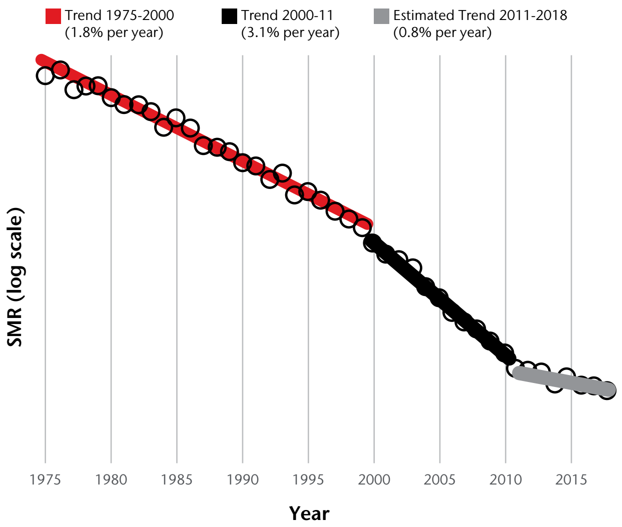
The first part of 2018 brought the ‘beast from the East’ with cold weather and heavy snow, which led to higher than expected mortality in the population that persisted into late spring. However, conditions in the second half of the year were much more benign, with lower levels of mortality seen in the population.

The total number of deaths in the population in 2018 was slightly higher than in 2017, but the population was slightly larger and older — once this has been allowed for, the death rates in the population were very similar to what they were in the previous year, meaning that there was no improvement in mortality in the population as a whole over 2018. This carries on a trend that we have seen since 2011, where mortality improvements for men have averaged just 0.8% per year – much slower than the 3.1% per year improvement that we saw over 2000-2011. These trends are shown in the chart below.



The data from 2018 reinforce a view that we have held for some time that we are now experiencing a distinct slower improvement trend than we saw in the first part of the century. With the latest version of its improvements model ('CMI_2018') the Continuous Mortality Investigation (CMI) also recognises this additional certainty over the new trend, and suggests placing more weight on recent years' experience by adopting a lower core value for the smoothing parameter (reducing it from 7.5 to 7.0).

We estimate that this change alone reduces a typical pension scheme's liabilities by around 1.5% compared with previous versions of the model – overall, adopting this model might reduce liabilities by around 2-2.5% compared to using the previous version.

It is less clear whether this model is directly relevant to pension scheme members. Our analysis of both:

- Aon's longevity dataset of pension schemes, and
- National data from the ONS broken down by socio-economic group

indicates that mortality improvements for pension scheme members and for the better off have fallen, but remain higher than those in the general population.

Trustees and sponsors need to consider carefully whether and how to adjust the CMI model to obtain mortality improvements assumptions that are appropriate for their pension scheme. It is important that this adjustment is based on data and sound principles. At Aon, we have developed a standard approach that takes explicit account of each scheme's socio-economic profile, while remaining consistent with the pattern of improvements observed nationally.

Previous versions of the CMI model only allowed users to easily reflect this by changing the level of smoothing within the model: this approach was somewhat opaque. The latest CMI model allows users to increase or decrease the initial rate of improvement, without changing the smoothing parameters. It has done this by introducing a new parameter 'A' that allows users to increase or decrease the period component of initial and historic mortality improvements by a fixed amount. This will provide a more intuitive way to allow for improvements in pension schemes being different to the population as a whole.

Dependants – a new approach

In today's low yield climate, assumptions about dependants (proportions of members with dependants and age difference) are more important than ever when valuing liabilities. This article explains the issues and how Aon can help clients tackle them.

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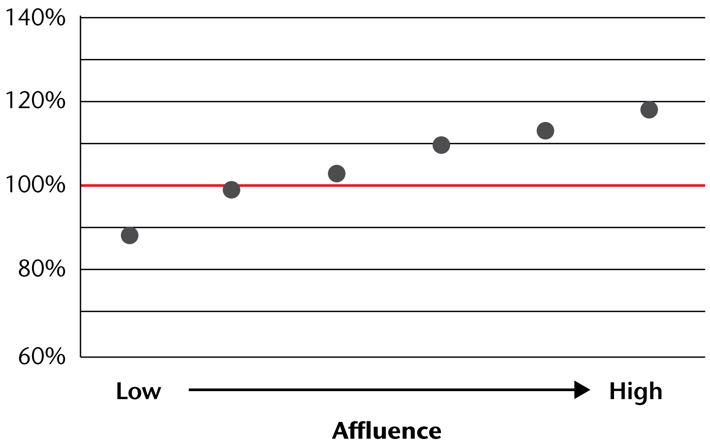
Why does this matter?

Understanding the appropriate demographic assumptions is crucial to knowing whether pricing terms are attractive. However, market-leading research Aon has carried out reveals that marriage rates vary significantly depending on a range of factors, including socio-economic status, as illustrated by this chart:



A 'one-size-fits-all' approach therefore risks significantly mis-stating liabilities – for example, the difference between the most and least affluent groups is equivalent to around 6% in liability terms.

What is right for my scheme?

Before settling benefits, we recommend obtaining either or both of survey and tracing data, as the most accurate means of assessing assumptions about dependants. However, we recognise that many clients considering risk settlement will not have this data and obtaining it can take time and incur costs.

To address this, we have used our research to develop a model, which predicts these assumptions based on basic member details alone (e.g, age, gender, postcode).

Our model is proven to predict both legal spouse and wider dependant assumptions reliably and can help to avoid nasty surprises when schemes come to transact - we have seen real-life cases of schemes seeing big changes in pricing once survey data has been obtained which could have been avoided by using our model.

Survey, tracing and death data

If any of these are available, they allow the assumptions to be refined. But they need to be handled with care, to avoid drawing incorrect conclusions. For example, survey data tends to overstate proportions married, as married members are more likely to respond. Aon, as the leading risk settlement adviser, has access to a significant volume of data allowing us to make sense of client data.

We can also help clients run survey and/or tracing exercises to improve data quality and are experienced in designing surveys to maximise response rates, giving improved certainty which can reduce the need for insurers to build in margins when pricing.

A combined approach

Even where survey or tracing data is available, it is unlikely to cover all scheme members (for example, not everyone will respond to a survey). Our approach combines any survey, tracing and death data available (after adjusting for biases) with our model based on membership profile. It uses a robust mathematical framework, validated on actual data, to predict assumptions about dependants with much greater accuracy and certainty than traditional approaches.

The challenge

- Assumptions about dependants vary significantly, for example depending on age, gender and socio-economic status
- The liability impact can be material, so setting these assumptions accurately is crucial
- Data traditionally used to assess these assumptions can take time and incur cost to obtain and be misleading

Our solution

- Aon's dependants model sets scheme-specific assumptions, correcting for biases in data and using membership profile information where no other data is available

Overseas

Review of overseas settlement markets

The pension risk transfer market is growing globally

The global risk settlement market continues to deliver opportunities to insure pension plan liabilities in part or in full. Transaction volumes continue to be dominated by the three established markets of the UK, the US and Canada.

Other markets, including Ireland and the Netherlands, continue to offer opportunities and there are exciting new developments such as the opening up of a potential market in Brazil.

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US

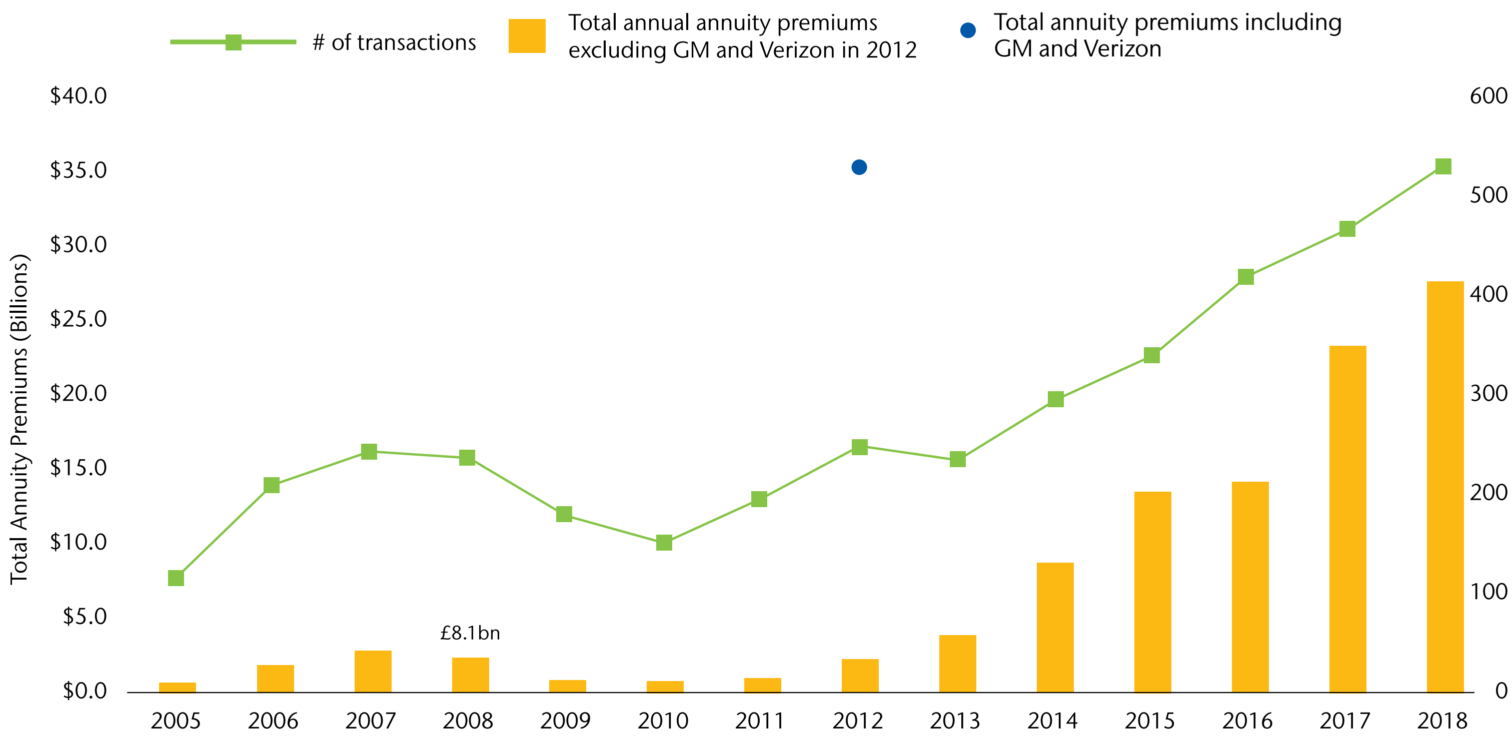
2018 was another huge year for the US annuity market, with exceptional growth and close to $27.5Bn of transactions completed. Corporate tax reform played a large part, with many sponsors opting to accelerate required pension contributions and some plans using these contributions for strategic pension settlements.

As in previous years, plan terminations and annuity lift-outs dominated the market, but in late 2018 Lockheed Martin's combined annuity lift-out and annuity buy-in created a buzz.

Unlike in the UK, annuity buy-ins are rarely used in the US, for regulatory and accounting reasons. Based on comments by Lockheed Martin, the buy-in structure assists with settlement cost recovery from contracts.

It will be notable if more future US annuity buy-ins transact because of the Lockheed deal. The Pension Risk Transfer ('PRT') market transacted three annuity buy-ins last year, aside from Lockheed.

Growth of US Pension Risk Transfer Market



Plan termination

A strategy where sponsors discharge all pension plan assets and liabilities (often via a combination of voluntary lump sums and an annuity purchase), and the plan ceases to exist.

Annuity lift-out

An alternate, more targeted strategy to buy out some current pensioners and, infrequently, some deferred participants. These lift-out strategies are popular for reducing plan liability and expenses without terminating the plan.

Insurer focus points

In 2018 we observed that more insurers migrated 'up-market' resulting from newer insurers quoting in the small to middle market segments. This dynamic created greater choice for sponsors.

It is now reasonable to secure three to six insurers on any US transaction. Aon-led deals had approximately 70% of their retiree lift-outs with five or more bidders up from three or more in 2017, with one deal attracting eleven bidders.

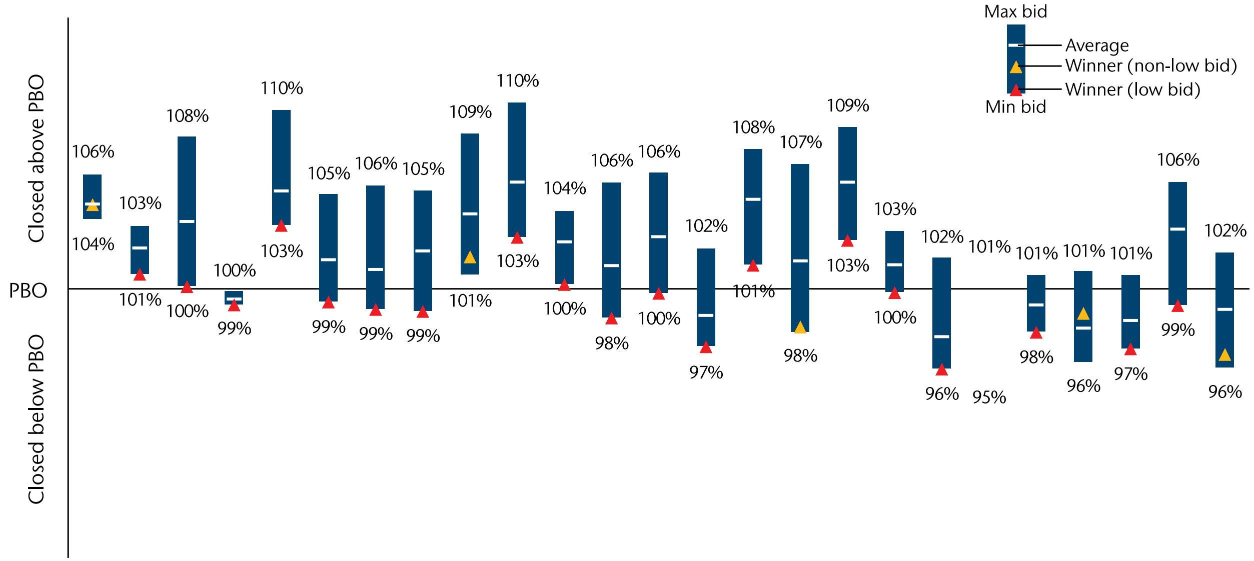
Innovation

US insurers are increasingly willing to support more complex PRT transactions including credit enhanced 'separate account' alternatives (similar to collateralised bulk annuities in the UK) and asset-in-kind transfers. Aon also witnessed independent fiduciaries engaged with greater frequency. Companies utilised independent fiduciaries more in plan terminations and some utilised them at lower deal sizes than in prior years.

Pricing

Insurer pricing was strong throughout 2018, with particularly aggressive pricing on larger deals where some transacted prices were lower than US accounting liabilities (PBO) – a feature not typically seen in the UK.

Sorted by increasing premium



In 2019, Aon expects to see a continuation of competitive annuity pricing with activity in the first quarter already substantially higher than last year.

Europe

Bulk annuity transactions across wider Europe are less frequent than in the established markets of the UK, the US and Canada. However, there are exceptions to this — Ireland continues to have an active bulk annuity market and Norway saw its first bulk annuity transaction in a number of years complete in 2018 — a sign of things to come?

The varying dynamic across Europe is caused by a range of factors – differing funding regimes resulting in fewer assets being available to fund transactions and varying risk appetites. However, with the maturing of DB pension schemes across Europe we expect to see markets gradually develop in multiple countries.

Brazil

Further afield, embryonic bulk annuity markets continue to develop in multiple territories. In Brazil, legislation changed in the second half of 2018, paving the way for bulk annuities. Multiple insurers are now evaluating entry into this market and several sponsors are considering the potential for settlement options. Pricing with activity in the first quarter already substantially higher than last year.

Biographies

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Dominic Grimley
Principal consultant

Dominic is a Principal consultant in Aon's Risk Settlement team. He has a wealth of experience of bulk annuity transactions and created several parts of our service, including our due diligence offering.

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Mike Edwards

Partner

Mike is a partner in Aon's Risk Settlement team. He has 15 years of pensions and insurance industry experience and previously led the new business team at Scottish Widows, where he was responsible for the negotiation and completion of over £2.5Bn since their market entry in 2015.

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Karen Gainsford
Principal consultant

Karen is a settlement adviser with broad experience across the market on bulk annuity transactions (both medically underwritten and traditional). Bringing skill and understanding to every transaction, Karen is authorised to advise on bulk annuity transactions and has worked with a range of clients with transaction sizes varying from £10m to £1.6Bn.

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Phil Curtis
Senior consultant

Phil is a senior consultant and full-time risk settlement specialist with almost 10 years' experience advising on bulk annuities. Formerly the Risk Settlement team's operations lead, Phil now focusses his time advising his own portfolio of clients as well as project managing some of Aon's largest transactions. Over the last few years he has played an instrumental role in helping more than 20 schemes complete annuity transactions totaling over £7Bn.

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Rhian Littlewood
Senior consultant

Rhian is a senior consultant in the risk settlement team, specialising in bulk annuities, and is also one of a group exploring commercial consolidators and their potential impact on our clients. Rhian has been with Aon for eight years and has been working on buy-ins and buyouts for most of this time.

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Hannah Cook
Principal consultant

Hannah has extensive experience and is authorised to advise on all types of settlement transactions. Since 2014, Hannah has advised on over £15Bn of successful risk transfer activity across many high-profile longevity swap and bulk annuity transactions. In 2018, Hannah advised on five large bulk annuity transactions, covering over £2Bn of liabilities, including those for Thomson Reuters, The Automobile Association and Bank of America Merrill Lynch.

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Matthew Fletcher
Senior consultant

Matt is a longevity specialist within our Demographic Horizons team, helping measure and communicate longevity and other demographic risks in the UK and overseas. Matt has more than 15 years' experience advising pension plans and the insurance sector. He previously held longevity-related and scheme actuary roles at Towers Watson and Hyman Robertson. Matt chairs the CMI's Self-Administered Pension Schemes Committee which investigates UK pension scheme data to produce mortality curves that are widely used by schemes and bulk annuity providers across the UK.

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Joe Hathaway
Senior consultant

Joe is a senior consultant and risk settlement specialist with over 12 years' experience in the industry. He has worked on a wide variety of transactions in his time, ranging from £5m to just under £1Bn, including a number of high-profile transactions in 2018 such as the £400m Somerfield Pension Scheme buy-in, as well as the £850m full scheme buy-out for PA Consulting. In addition to working on his portfolio of clients, Joe is part of a team that is helping to develop and promote Aon's offering for sub-£30m transactions.

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Tom Scott

Principal consultant

Tom is a principal consultant and has wide-ranging settlement experience helping clients with their longevity risk management, and executing longevity hedging under a variety of different structures. Tom's recent projects include the completion of a £2Bn longevity swap, and executing a £400m partial pensioner buy-in.

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Kishore Ananda
Senior consultant

Kishore is a senior consultant in the Demographic Horizons team at Aon, specialising in (a) managing longevity risk transfer transactions and (b) mortality modelling and analysis. Kishore's clients include large pension schemes and UK and overseas insurers and reinsurers. Kishore has also assisted the CMI's Mortality Projections Committee.

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Andy Harding
Senior consultant

Andy is a demographic modelling specialist, leading Aon's research on contingent dependant assumptions, including marital tracing and age difference analytics. He also manages Aon's firm-wide delivery of longevity modelling for clients. Andy has advised on multiple longevity risk transactions, and ran the detailed data due diligence process in relation to the BT Pension Scheme longevity swap.

Andy is a member of the CMI's High Age Mortality Working Party, investigating the methods and limitations of calibrating mortality curves into very high ages.

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Andrew Cooper
Senior consultant

Andrew has over 10 years' experience in advising financial sector clients on all aspects of pension scheme de-risking. As well as being part of the Risk Settlement team, he is also a member Aon's Financial Sector Group which focuses on industry trends including considering the implications of settlement activities on regulatory capital. This includes meeting with the Prudential Regulatory Authority annually. Andrew is currently advising on both bulk annuities and longevity swap projects ranging from £100m to multi-£Bn transactions.

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John Baines
Partner

John is a partner and head of Aon's Bulk Annuity team. John led the development of Aon's Bulk Annuity Compass platform, which was built using his experience of delivering exceptional annuity pricing for his clients. He has advised on settlement projects between £5m and £8Bn and has been the strategic lead on a number of high-profile annuity cases in recent years including Kingfisher, Wolseley, Morrisons and Rentokil.

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Martin Bird
Senior partner and head of risk settlement

Martin is a qualified actuary and authorised to provide advice on insurance and capital markets transactions, and leads Aon's Risk Settlement team. Martin has led many of the industry's high profile risk transfer transactions and his extensive range of experience allows him to bring insight from both a pension scheme and investor mindset. Martin is frequently sought out by trustees, sponsors and the media and is widely recognised as one of the UK's leading settlement advisers.

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Michael Walker
Principal consultant

Michael is a principal consultant and senior risk settlement adviser. His extensive annuity experience comes from both sides of transactions having led one of Legal & General's bulk annuity pricing teams prior to joining Aon's Risk Settlement Group in 2016.

Michael completed £1Bn of bulk annuity transactions in 2018 including PA Consulting's £850m buy-out and Hitachi's £100m pensioner buy-in.

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Richard Thornley
Senior consultant

Richard has over 15 years' of experience advising on a wide range of pension risk management issues, and now specialises in providing advice on longevity and other demographic risks. He has recently played a key role in developing Aon's model for scheme-specific assessment of proportions married.

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Tiziana Perrella
Principal consultant

Tiziana is a principal consultant and brings extensive experience in bulk annuity transactions and scheme wind-ups, both solvent and insolvent.

Since 2008, she has been working exclusively in the risk settlement area and has been the lead adviser on over 100 buy-ins and buyouts with different insurers. Tiziana has been instrumental in the development of Aon's small scheme proposition.

About Aon

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