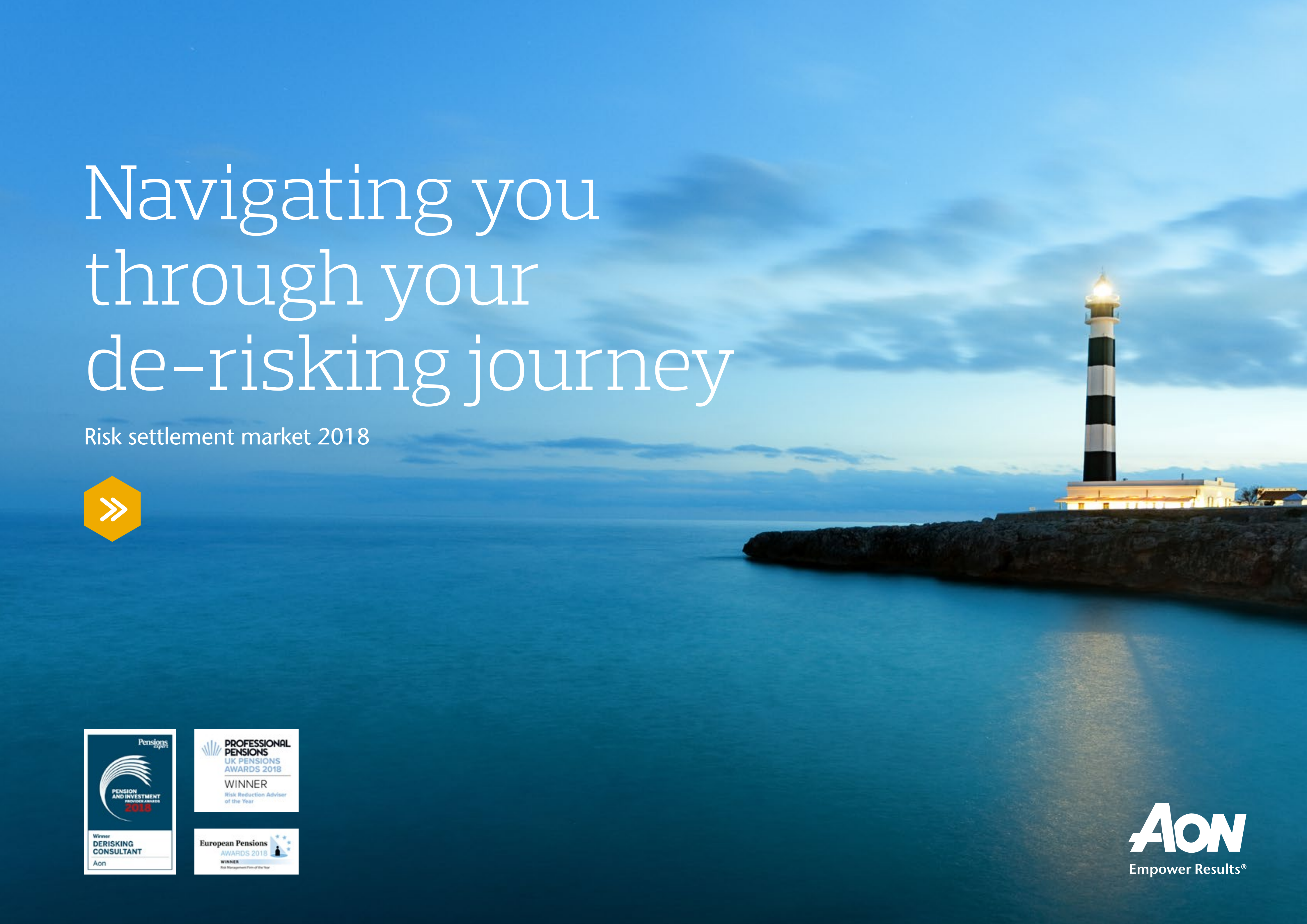


Navigating you through your de-risking journey

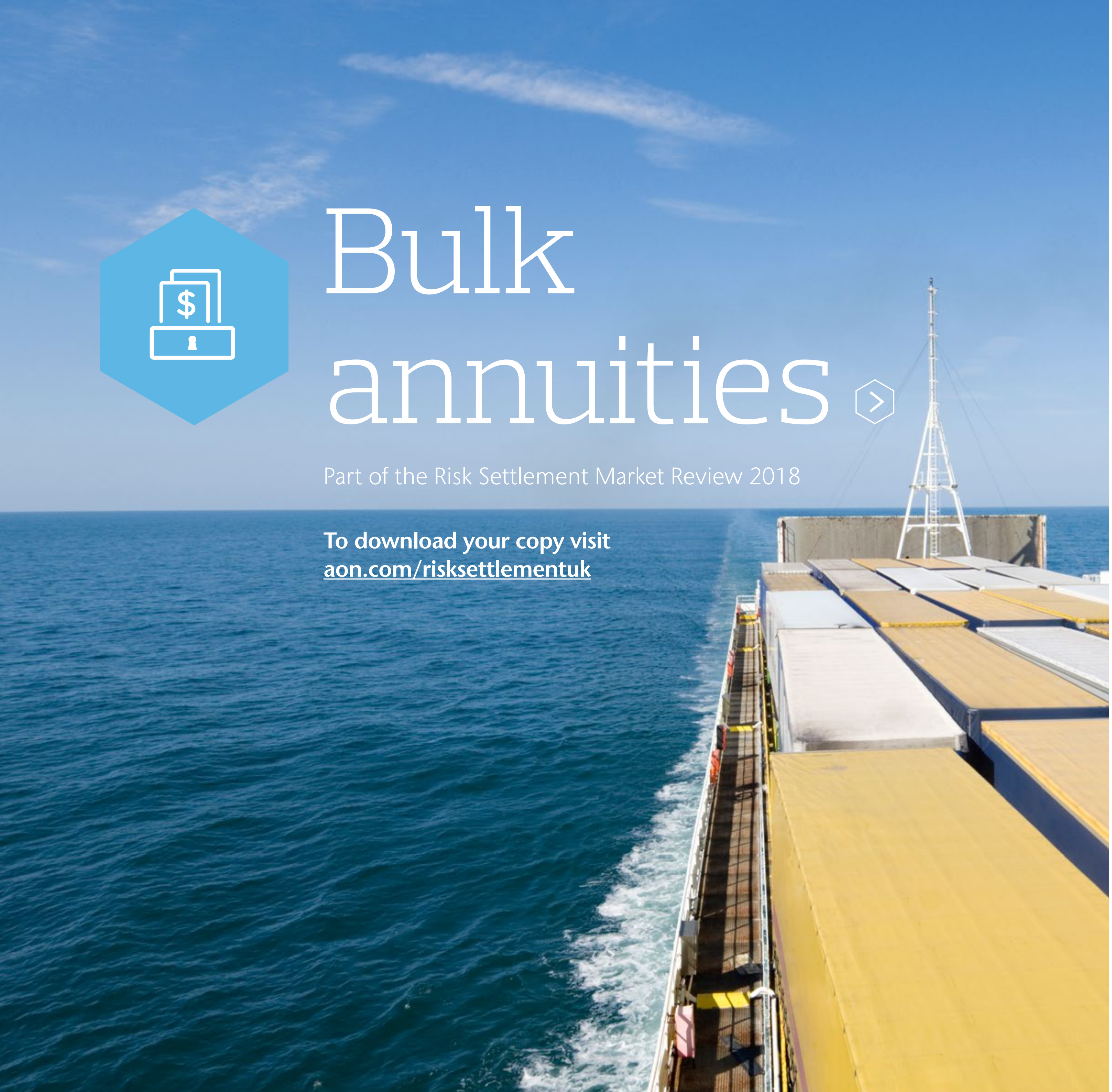
Risk settlement market 2018

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

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

European Pensions
AWARDS 2018
WINNER
Risk Management Firm of the Year

AON
Empower Results®



Bulk annuities

Part of the Risk Settlement Market Review 2018

To download your copy visit
aon.com/risksettlementuk

A year of increasingly strong market opportunities

It is safe to say that 2017 was a vibrant year for the bulk annuity market, with eight active insurers seeking to write significantly sized business. Having updated their business models to adjust to the Solvency II regulatory regime, they were ready to move forward, and with the insurance back-book activity on the back burner, their key source of business was company pension schemes.

Better prices, stronger competition

Firstly, we saw annuity pricing improve notably in 2017. Competition was also strong, with a greater range of asset opportunities used to maximise yield, alongside lower costs for hedging longevity risk and the removal of some conservatism (applied when Solvency II requirements were unclear). All of this played its part in welcoming some of the best annuity prices seen since the credit crunch of 2008.

Key points

- 2017 saw the expanded market gear up for greater volumes
- Strong price opportunities for ready schemes
- Buyout is becoming a more achievable target

Growing auction opportunities

By the summer of 2017, this opportunity was becoming clear to a large range of schemes, which led to an increase in auctions later in the year – with many spilling over into 2018. 2018 is expected to see record volumes of bulk annuities, including insurer back-book transactions – with Rothesay Life's acquisition of £12bn of Prudential annuities already announced.

To avoid a shortage of available resource, insurers are being increasingly selective before agreeing to quote. In particular, they are keen that new auctions are carefully prepared – with clear parameters for execution – before being willing to invest time and effort in producing detailed quotations.

Moving trends

Despite a year of record pricing, unusually, there were no transactions over £1bn. In part, this reflected the trend towards securing benefits in tranches – either from repeat buyers, who had already secured much of their pensioner liabilities and were simply 'topping up', or from schemes taking a more gradual approach to integrating annuities into funding and investment strategies.

Largest disclosed 2017 transactions

Source	Insurer	Size (£m)	Membership secured
Dockworkers	PIC	725	All
Pearson	Aviva	600	Pensioners
Pearson	L&G	600	Pensioners
Ferguson	PIC	590	Pensioners
Plumbers	L&G	570	Pensioners
Merchant Navy	L&G	490	Pensioners
Royal Mail	Rothesay Life	450	All

Buyout buoyancy

Many providers had a particular interest in either pensioner-only deals or full scheme transactions, reflecting their competitiveness for different profiles. This led to competitive auctions, even for those schemes with a large proportion of younger members or members who have not yet retired. The attractive pricing also meant that many schemes found themselves much closer to full scheme buyout than they might have predicted at the start of the year. We estimate that around a quarter of transactions by volume were full scheme buyouts.

	2017		2016	
Provider	**Value (£m)**	**Number of deals**	**Value (£m)**	**Number of deals**
PIC	3,704	26	2,529	17
Legal & General	3,405	31	3,339	21
Aviva	2,045	34	1,477	41
Just Group*	998	22	620	21
Rothesay Life	960	5	-	-
Scottish Widows	645	8	943	4
Canada Life	544	6	145	4
Phoenix	-	-	1,181	1
TOTAL	**12,301**	**132**	**10,234**	**109**

*Just Group data includes business written as Just Retirement and Partnership.

Our survey showed that:

25% of clients had completed at least their first **annuity transaction**

50% **would secure the whole of their final salary** scheme liabilities in the annuity market if they had the money to do so

Some of the **remaining schemes are also likely to secure their liabilities over time** but after the deferred membership has matured further, potentially following member option exercises as well as natural progression

Source: Aon's Risk Settlement Survey 2017

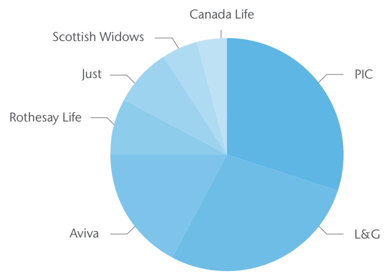
Plentiful opportunities

As shown in the table to the left, there were £12.3bn of bulk annuity transactions in 2017 – this is similar to 2015 levels, with 2016 temporarily lower (£10.2bn excluding back-books), because of the distractions of Solvency II implementation and back-book deals.

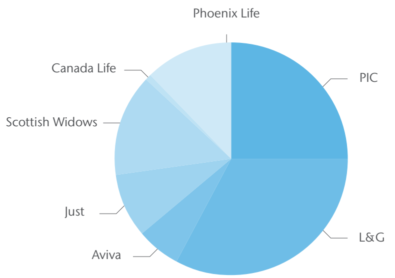
Given the pricing available, this suggests some schemes are missing opportunities that they could capture. For example, it could be fruitful for some to reduce allocations to low-yielding gilt and LDI portfolios, provided they can maintain their current level of interest rate protection while gaining the wider benefits of annuities.

Insurer market share, 2015–2017

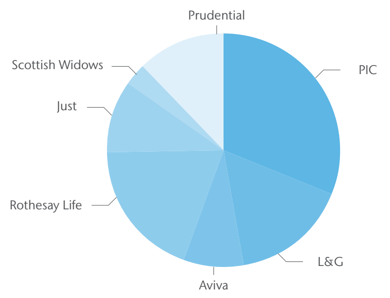
2017



2016



2015



Market movers and shakers

PIC and L&G continued to lead market share in 2017, writing a wide range of transaction types and sizes. Aviva's growth plans were however also very evident, with their business rising dramatically from £0.9bn in 2016 to over £2bn, and a busy start to 2017 suggesting the group will increase volumes further.

While Rothesay Life placed less business in 2017, this fell in between digesting a then record £6.4bn of back-book transactions in 2016, and before its £12bn transaction in 2018 to take on part of Prudential's closed annuity book. Prudential's proposed split into two entities, leaving an asset management focused company writing business in Europe, suggests there will be further annuity back-book opportunities in the coming years.

Scottish Widows has the capacity to significantly increase volumes in 2018, with an expanded product offering including full scheme transactions.

Canada Life became more established in the bulk market in 2017, disclosing two substantial transactions over £0.2bn each.

Meanwhile, Phoenix Life launched its offering in 2017 and is expected to announce bulk annuity transactions in 2018, following its £1.2bn transaction for Phoenix's own group scheme at the end of 2016 and its recent life company acquisition from Standard Life Aberdeen.

Just Group has continued to write steadily, revamping its offering to support larger buy-ins and to provide a range of options to incorporate medical underwriting into smaller deals.

Get in touch to find out more here

Dominic Grimley
dominic.grimley@aon.com

Tullett Prebon with Rothesay Life

Full scheme bulk annuity

The preparation

Preparation was key for the Tullett Prebon deal with Rothesay Life. We first conducted a feasibility study in summer 2015, long before approaching the market, on the back of an improved funding level. This resulted in a detailed plan of action to get the scheme in a better position, which included:

- A series of member option exercises, including flexible retirement offers and enhanced transfer values
- A staged data cleansing programme
- A series of discussions with stakeholders to agree when de-risking would be acceptable to a scheme invested 100% in high-performing growth assets
- Establishing a new asset manager and de-risked asset strategy, to be adopted as a transitional structure when the time is right
- Planning how to deal with a series of ‘uninsurable’ benefits, such as a salary link and complex benefit underpins
- Closer monitoring of the solvency position and of the market.

The preparatory steps were carried out during 2015-2016, helping the scheme’s funding position to improve dramatically.

As soon as auction pricing was obtained and analysed, the assets were fully de-risked – with a fast move made possible due to the thorough preparatory work. This locked in a material surplus.

Key points

- Advance planning captured strong pricing
- Surplus locked in quickly through transitional asset strategy
- Not all barriers to wind-up prevent a transaction

The outcome

A price lock was agreed with the winning insurer, Rothesay Life, based on the scheme's own new asset profile. A tailored contract was agreed, covering residual data risks in as much detail as possible. Overall, the timing capitalised on a dramatic period of asset returns and falling annuity pricing to capture the surplus from a volatile position. The final pricing reflected the confidence of providers that the scheme would transact and should therefore attract their best asset opportunities on offer.

'Aon showed a lot of commitment to ensure the trustees could secure the risks of the Tullett Prebon pension scheme as quickly as possible. Their market knowledge, attention to detail and work ethic kept the project on track. This was a complex and bespoke transaction where fast reaction and genuine project management were important.'

Clive Gilchrist, BESTrustees

The lessons

Some key buyout takeaways learnt from this deal include:

- The importance of planning ahead and integrating the planning of different exercises leading to buyout, in order to avoid missed opportunities
- A scheme that seems to have clear barriers to transaction, such as hard-to-insure benefits, can secure terms in practice before solving each issue – provided there is thought given to how benefits will ultimately be replaced with insurance
- Timely asset switches can dramatically reduce the time to buyout
- It is important to consider the protection that the trustees and sponsor want for residual risks in advance, such as data uncertainty, and the acceptable price to pay for these risks
- Solvency estimates need to be examined closely as a transaction starts to become potentially affordable – it is often the case that the deficit gap can be closed in the final throes of a competitive auction process.

Get in touch to find out more here

Dominic Grimley
dominic.grimley@aon.com

Innovative asset strategies support better annuity pricing

Under Solvency II (the EU directive that governs the amount of capital that insurers are required to hold), annuity providers are strongly encouraged to back annuities with assets generating income that closely matches the stream of benefit payments expected in future. Their asset portfolios therefore consist of long-term assets with predictable income. Interest rate, inflation and, in many cases, longevity risk, are substantially hedged.

Key points

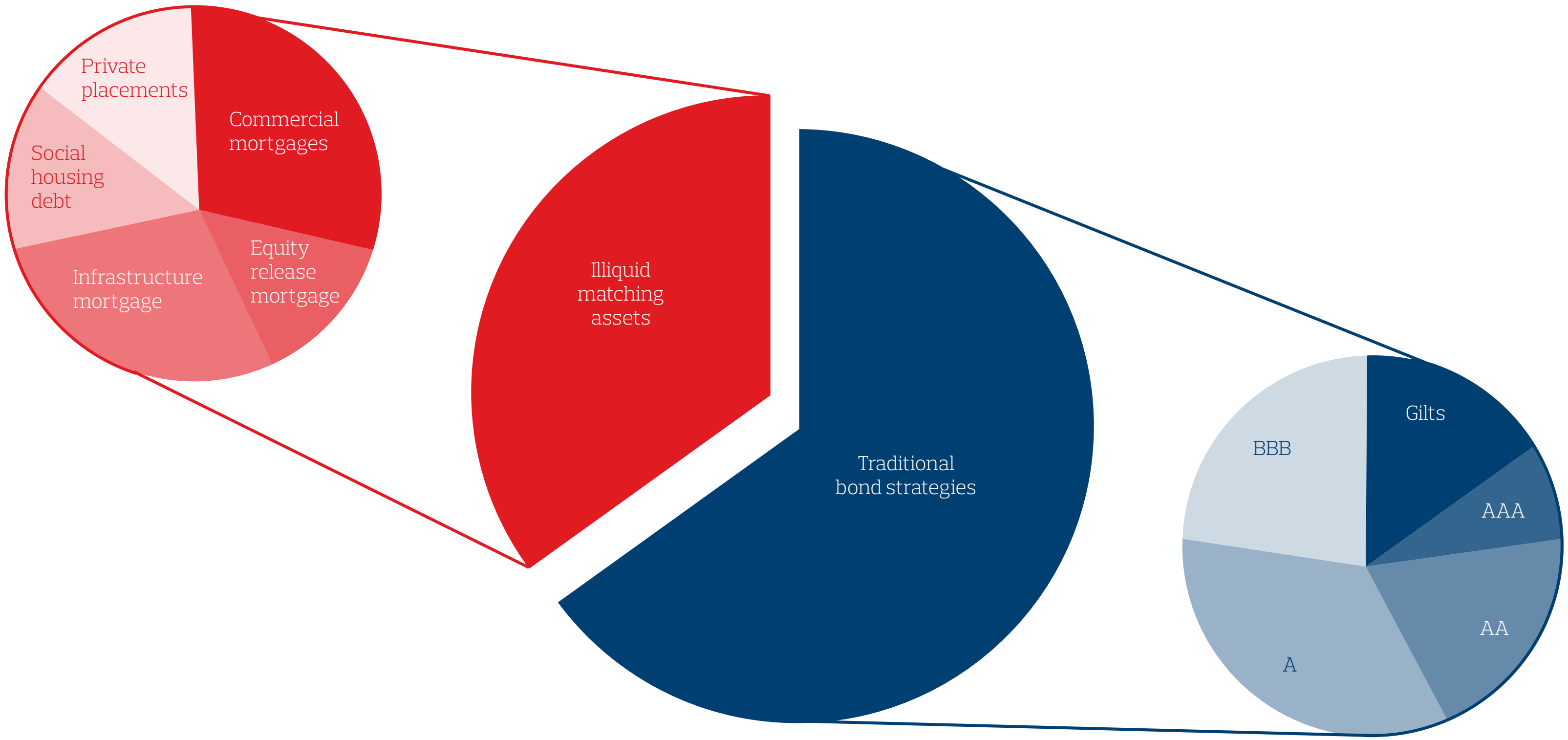
- Insurers proactively looking to optimise yield for annuity assets
- Low bond yields make alternative assets attractive
- Innovation thriving, despite the regulatory requirements

The quality of the assets, in terms of credit rating (allowing for any collateral support), is also carefully considered, as riskier assets mean higher reserving requirements.

Despite these constraints, we have seen a definite move by insurers to diversify the assets they hold to back annuity policies. This was partly encouraged by a more stable regulatory environment since Solvency II was introduced in 2016, as well as political encouragement to invest in socially beneficial infrastructure projects. This development, in part driven by a competitive market, has meant that insurers are increasingly moving away from the traditional approach of investing in corporate bonds to find alternative higher-yielding assets which help them support better pricing.

Some of the insurers have been able to tap into useful in-house asset sources. For example, Just, L&G and Aviva are three of the main issuers of equity release mortgages, and this asset class has been increasingly used to back annuities – many of the other providers have also now found ways to access this asset class. A technical issue is that equity release mortgages do not deliver a predictable enough yield to meet the Solvency II requirements to be a 'matching' asset. However, this can be addressed by internal securitisation, with an associated company sourcing the asset and issuing debt securities to the annuity provider which produce predictable income funded by the returns on the portfolio of mortgages. This approach means that the income can be shaped to be in optimal form for backing annuities.

Insurers lacking an in-house asset source have been creative about developing other means of accessing suitable assets, through tie-ins with other organisations and by recruiting dedicated sourcing teams, each focused on a specific asset class. By becoming a key investor in a particular area, they can still have a significant influence on the structure of the investment (often securitised), particularly in terms of the duration and shape of income it produces.



Commercial mortgages, senior infrastructure debt, private credit, ground rent and stock lending to banks are among the other asset classes increasingly used by annuity providers to deliver income with an improved yield and/or better matching qualities than investing in corporate bonds. Some insurers have found that this allows their annuity business to tackle social responsibility both by supporting pensions and by investing in projects that benefit the less affluent. Examples of this are PIC participating in several social housing programmes, and L&G launching a low cost house-building business a few years ago.

This innovation in sourcing alternative assets is key to the annuity market's development, as the level of issuance of listed credit (the traditional asset class for insurers) has been volatile and as credit spreads have reduced in recent years. The success of insurers in this area has been a major factor in their being able to offer the very attractive pricing, and these capabilities will be increasingly critical in future if the market is to cope with the increased demand that we are anticipating.

Get in touch to find out more here

Paul Belok
paul.belok@aon.com

Effective scheme preparation

Pre-Compass Checklist

If 2017 highlighted one thing, it was the crucial importance of thorough preparation when it comes to securing the best pricing in the market. But what does effective preparation actually look like? In 2017, well-prepared, successful schemes were able to:

- Demonstrate commitment to the transactions, meaning that insurers were willing to participate in auctions as well as allocate high yielding assets to support their pricing, rather than re-directing those assets elsewhere
- Reduce the margins that insurers include in their pricing for uncertainties over data.

Key points

- If unprepared, schemes may struggle in the upcoming busy 2018 market
- Preparation will reduce the margins that insurers include in their pricing

Preparing your scheme: where to start

The first step? Education. Seven in 10* schemes believe that they would need further training before embarking on a settlement exercise. The next step is preparation – where our Pre-Compass Checklist is crucial. It ensures our clients are well positioned to achieve the most competitive pricing for their liabilities.

*Source: Aon's Risk Settlement Survey 2017

Item	Establishing a de-risking framework	Status / actions
Long-term objectives	What are the trustee and company's long-term objectives?	Buyout
Monitoring pricing opportunities	Does the scheme have a process for monitoring market pricing to identify opportunities (eg, using Aon's Risk Analyzer)	Review BAMM updates, no specific monitoring in Risk Analyzer
Target price	Has the scheme identified a transactable pricing level? (eg, would the trustees and company transact if this could be done on a funding neutral basis)?	To be determined, explore as part of feasibility study
Impact on financial metrics	Has the scheme considered the impact of a transaction on financial metrics (eg, funding, expected return, value at risk and accounting)?	To be determined, explore as part of feasibility study
Availability of cash funding	Is the company likely to be prepared to pay additional contributions to facilitate a buy-in/out?	To be discussed with the company
Setting an overall strategy – a phased approach	Over what time does horizon buyout or self-sufficiency look achievable? Does it make sense to capture pricing opportunities and settle benefits through partial buy-ins over time?	Buyout not achievable for 5+ years, consider tactical settlement opportunities in the short term
Setting up a sub-committee	• Has the scheme established a steering or sub-committee to consider settlement further? • How will the trustees and the company work together in a settlement process? • Would the sub-committee have any delegated powers? (Need to consider 'go' and 'no go' decision points)	To be established
Power in trust deed and rules	Does the trustee have the power to carry out a buy-in/out?	To be established – check scheme rules

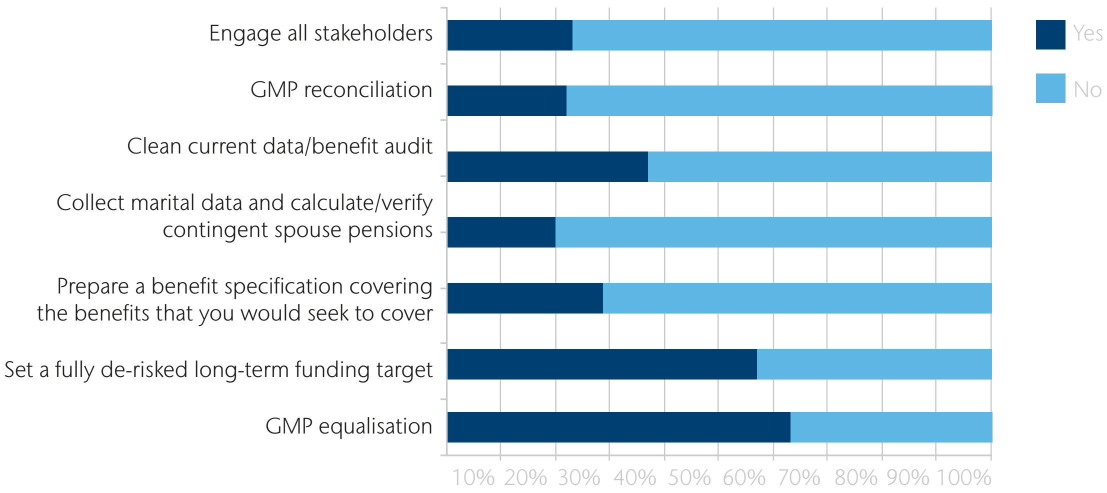
How ready is your scheme?

Around 25% of our clients* now see themselves as either ready, or close to being ready, to insure their pension scheme liabilities via a bulk annuity or a longevity swap. Their preparation work is nearing completion and they are well-placed to go to market when the time is right for them. On the flip side, Aon's key prediction for 2018 is that schemes that are not properly prepared will struggle in the upcoming busy market.

*Source: Aon's Risk Settlement Survey 2017

Based on our research, the chart below shows the extent of work done across seven key areas of preparation in 2017. And, as you can see, the results are mixed. Over the year, there was an increased focus on cleaning data and checking that benefits were being paid correctly. However, the next stage of collecting and recording additional data – important for insurance quotations (marital data and spouses' pensions) – has not been tackled by many schemes. Engagement with the scheme sponsor should also not be underestimated as, to secure the best pricing, all stakeholders will need to demonstrate commitment to the transaction.

Which steps have already been taken or are planned in the next 12 months to prepare for a future settlement exercise?



Source: Aon's Risk Settlement Suvey 2017

Pre-Compass Checklist will help prepare you for success

Karen Gainsford
karen.gainsford@aon.com

Key opportunities for smaller schemes

– and how to make the most of them

Did you know that smaller schemes are still able to obtain competitive quotes from up to four insurers? Aviva, Just and Canada Life have no minimum size requirements. Legal & General also do not have a stated minimum, although they tend to be very selective in this space.

Approaching it right

In order to obtain maximum engagement from insurers, smaller schemes need to provide evidence that they are well prepared to complete a transaction. This includes having the correct data, benefit information and governance in place so that a transaction can proceed very quickly if the price is right.

As an alternative, smaller schemes may be happier to select a preferred counterparty in advance and obtain a quotation on an exclusive basis. Setting a challenging, but realistic, trigger price is fundamental if this model is followed.

Key points

- Smaller schemes can obtain quotes from Aviva, Just, Canada Life and Legal & General (although selective)
- Competition in the medical underwriting space is down but there is potential for underwriting savings here
- Buyout pricing may look attractive for smaller schemes once ongoing management costs have been taken into account

What is happening to the medically-underwritten market?

Medical underwriting is particularly relevant to smaller schemes, as they may have higher levels of concentration risk, with a significant proportion of the scheme liabilities being in respect of only a few members. It is also more likely that scheme trustees will have relevant knowledge in respect of the membership.

Following the merger of Just Retirement and Partnership (the joint entity is now known as 'Just'), competition in this segment of the market has reduced significantly. It is still possible to take advantage of potential savings from underwriting by following a model where underwriting is carried out after a transaction completes, and a proportion of the savings is rebated to the scheme (but no balancing payment is due if the results from the underwriting exercise are disappointing). This model assumes that the chosen insurer was competitive to start with on a non-underwritten basis.

To buyout or not to buyout?

Buyout pricing may look particularly attractive for smaller schemes once the ongoing costs of keeping the scheme running are taken into account, as these can be proportionately much greater than for bigger schemes.

Insurers can offer a contract structure in which a proportion of the full premium is paid upfront (no less than 75% of the full premium). The insurer takes on the risk immediately, with the scheme retaining the payroll until the unpaid proportion of the premium is amortised. This structure can fit with the existing schedule of contributions – as the sponsor simply continues to pay the contributions that have already been agreed until the end of the recovery plan, with no residual risk.

Attractive bulk annuity deals are available for schemes of all sizes

Tiziana Perrella
tiziana.perrella@aon.com

About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

For further information on our capabilities and to learn how we empower results for clients, please visit **aon.mediaroom.com**

Aon Hewitt Limited is authorised and regulated by the Financial Conduct Authority. Aon Hewitt Limited Registered in England & Wales.
Registered No: 4396810. Registered Office: The Aon Centre, The Leadenhall Building, 122 Leadenhall Street, London EC3V 4AN.

Empower Results®