

Buy-outs and Buy-ins Report 2015



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Gavin Markham
Head of Bulk Annuities
Barnett Waddingham

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The advent of the new pension flexibilities introduced in April 2015 has a number of potentially significant impacts for the bulk annuity market – all of them positive.

The bulk annuity market comfortably broke all previous records with over £13bn of business transacted in 2014. The first half of 2015 has shown a rather more steady start, and so while this year may not necessarily hit these highs, we still anticipate another strong year.

Insurance solutions are an ever increasing focus for the vast majority of defined benefit (DB) schemes as they continue to mature and progress along their respective de-risking journeys.

The multi-billion pound transactions for the ICI Pension Fund and the TRW Pension Scheme completed in 2014 demonstrated the feasibility of very large deals, supported by the strong appetite of both the insurers and reinsurers for longevity and wider bulk annuity risks. Over the longer term, given the inherent scale of the demand from UK DB schemes, it is possible that some capacity constraints will begin to emerge as more schemes look to de-risk. In particular, limiting factors such as the supply of suitable backing assets or longevity reinsurance may tend to put upward pressure on pricing.

The growth of the medically underwritten bulk annuity market continues to offer attractive pricing opportunities, with the total volume of business carried out by the specialist insurers now heading towards £1bn. The development of ‘top-slicing’, where the benefits of the largest liability members are secured, has also opened up the option for much larger schemes. This approach can now provide a potentially cost-effective way of removing the concentration of longevity risk for schemes of any size.

The advent of the new pension flexibilities introduced in April 2015 has a number of potentially significant impacts for the bulk annuity market – all of them positive.

Firstly, the adverse effect on the individual retail annuity market of removing the requirement to purchase an annuity has helped to boost the level of competition in the bulk annuity market. To date, this has largely been through the increased appetite of the existing insurers operating in both areas, but it has also added support to the emergence of potential new providers, with some new insurers anticipated to enter the market in the second half of 2015.

Secondly, any increase in the number of DB members transferring to defined contribution (DC) schemes is likely to enhance funding levels resulting in improved transaction affordability for schemes and their sponsors. Finally, over the longer term, if credible experience of increased individual transfers develops then this can ultimately be reflected in the insurers’ pricing.

Introduction

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Looking forward, schemes will need to ensure that they are well positioned to take advantage of opportunities as they arise, particularly in a competitive market where demand is only likely to increase.

Liability management options more generally, including transfers and the re-shaping of benefits, are an important tool which schemes can use to improve the potential affordability and therefore feasibility of a transaction. Our clients have shown increasing interest in this area as a way of supporting a transaction, either in the immediate term, or as part of a longer term de-risking approach.

Looking forward, schemes will need to ensure that they are well positioned to take advantage of opportunities as they arise, particularly in a competitive market where demand is only likely to increase. Understanding the range of options, making the right choices and carrying out the appropriate preparatory steps will be key in achieving the best possible outcome.

In addition to an overview of the bulk annuity market, in this report we have highlighted some of the important issues for scheme trustees and sponsors to consider in relation to either a buy-in or a buy-out.

We would be more than happy to discuss any issues relating to this report, or bulk annuities and de-risking more generally, with you and hope that you find this report useful.

For further information please contact me.



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Buy-outs and buy-ins market activity

The transactions completed by the UK bulk annuity insurers over 2014 were as follows:

Number of transactions - 2014

	Q1	Q2	Q3	Q4	Total
Aviva	17	13	17	13	60
Canada Life	7	-	-	1	8
Just Retirement	3	3	3	13	22
Legal & General	5	11	11	8	35
Partnership	2	3	-	2	7
Pension Insurance Corporation	5	4	1	9	19
Prudential	3	1	2	1	7
Rothsay Life	3	2	2	3	10
Total	45	37	36	50	168

Value of transactions (£m) - 2014

	Q1	Q2	Q3	Q4	Total	Average transaction value (£m)
Aviva	135	128	487	123	873	15
Canada Life	1	-	-	-	1	0
Just Retirement	37	50	25	330	442	20
Legal & General	3,051	85	228	2,619	5,983	171
Partnership	34	3	-	210	247	35
Pension Insurance Corporation	148	1,649	170	590	2,557	135
Prudential	730	304	376	300	1,710	244
Rothsay Life	259	322	305	510	1,396	140
Total	4,395	2,540	1,591	4,681	13,208	79

Source: Insurers - any differences due to rounding

Buy-outs and buy-ins market activity

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In terms of the volume of business, 2014 was the most successful year for the bulk annuity market so far with more than £13bn of business completed.

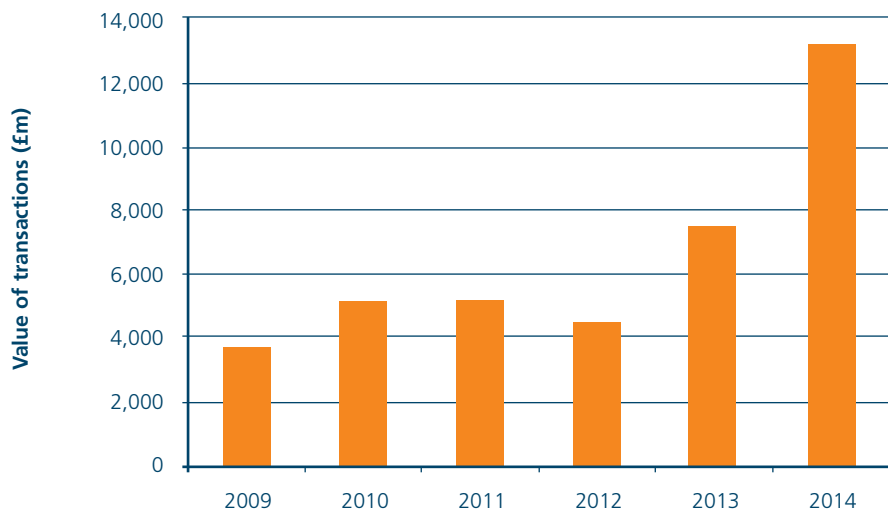
In terms of the volume of business, 2014 was the most successful year for the bulk annuity market so far with more than £13bn of business completed – this compares to an annual average of around £5-6bn for the previous five years. This record-breaking year was helped by some very large transactions including a £3.6bn buy-in for the ICI Pension Fund and a £2.5bn buy-out for the TRW Pension Scheme.

“We would categorise 2014 as a success in terms of volume of business written, but this was achieved with a lower number of transactions. We believe future developments will see a continuation of innovation for mega deals but with an increased capacity for smaller deals as the efficiencies and innovation filters down.”

AVIVA

The value of bulk annuity transactions completed by UK insurers over the last few years is shown below.

Total bulk annuity business



Source: Insurers

While the volume of business hit new highs, the number of transactions completed actually fell in 2014, with 168 completed compared to 213 in 2013. The emergence of larger deals is likely to increase insurers’ focus on the allocation of their resources, committing to those cases which look both attractive and where there is a strong likelihood of a transaction completing.

Buy-outs and buy-ins market activity

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The growth of medically underwritten transactions continued to gain momentum in 2014, with over £600m of business being written by the specialist providers during the year.

The growth of medically underwritten transactions continued to gain momentum in 2014, with over £600m of business being written by the specialist providers during the year. Partnership announced the largest medically underwritten transaction to date with a £206m pensioner buy-in for the Taylor Wimpey Pension Scheme in December. This transaction insured the pensioners who had the largest liabilities in the scheme – a process known as top-slicing.

However, 2014 wasn't good news for all insurers. After a year of speculation, MetLife Assurance formally exited the market with the transfer of their historical business to Rothesay Life.

New Providers

Following the removal of the requirement to purchase an annuity for DC scheme members in the March 2014 Budget, a number of individual retail annuity providers have been increasingly focused on the possibility of joining the bulk annuity market.

While it has taken some time for them to develop their offering, we expect several new providers to emerge over the course of 2015. This includes Scottish Widows who has already declared their intention to enter the market in the second half of the year. The entry of new providers is expected to have a beneficial impact on competition in the market, and is likely to be particularly helpful for small to medium sized transactions.

“We believe that both demand and supply are set to grow in this market. On the demand side, only around 5% of the £1.8 trillion of UK pension scheme liabilities have been de-risked using insurance.”

“On the supply side, the recent pensions freedom changes have meant that some of the insurance risk capital that was previously allocated to the retail annuity market will now be diverted towards the bulk annuity market, which should increase market capacity. We also expect to see continued innovation with the bulk annuity market in order to help pension schemes de-risk, in particular in light of the pension freedom changes.”

LEGAL & GENERAL

Insurer pricing - is a transaction affordable?

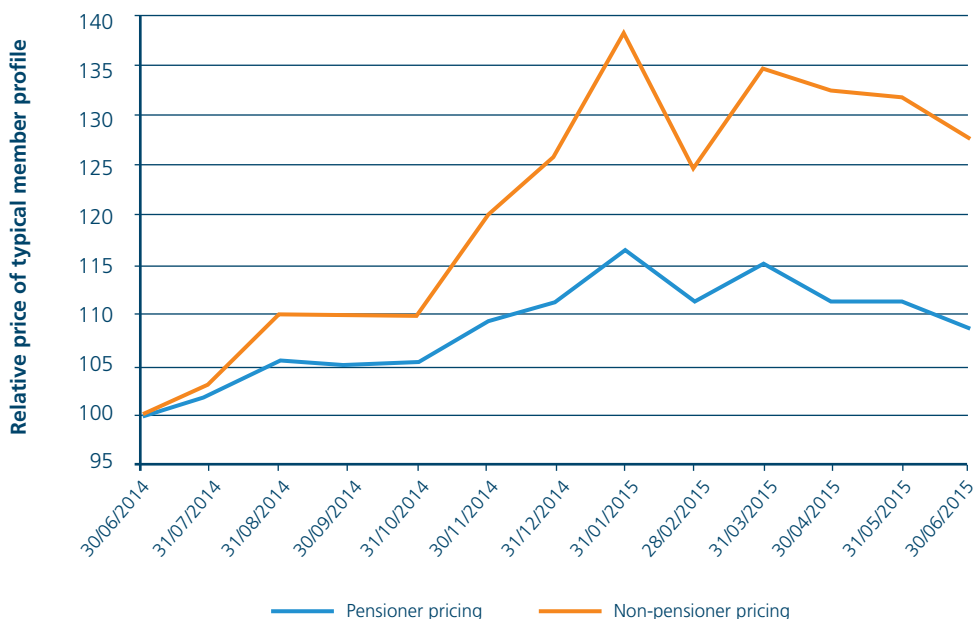
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Bulk annuity pricing in absolute terms increased significantly over the second half of 2014 and the beginning of 2015, primarily as a result of the fall in the long-term yields available on gilts and corporate bonds.

Insurer pricing - is a transaction affordable?

Bulk annuity pricing in absolute terms increased significantly over the second half of 2014 and the beginning of 2015, primarily as a result of the fall in the long-term yields available on gilts and corporate bonds. The impact was greater for non-pensioners, compared to pensioners, due to the longer duration (i.e. weighted average term to benefit payment) of the non-pensioner liabilities which results in a greater sensitivity to falling long-term yields. This is shown in the following chart which illustrates the movement in pricing over the last twelve months for a typical non-pensioner and pensioner membership profile respectively.

Sample pensioner and non-pensioner pricing



Source: Barnett Waddingham model using pricing information from a range of leading insurers. In practice, any actual pricing will depend on the specific characteristics of the scheme.

Insurer pricing - is a transaction affordable?

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Liability management through the provision of member options can also be used by schemes to improve transaction affordability.

The movement in the position for schemes considering a potential full buy-out will have depended on a number of specific factors including how well funded they were initially, the level of investment de-risking already in place and the performance of their growth asset holdings.

For the majority of schemes, despite the generally strong performance of growth assets (e.g. equities) over the course of the last year or so, it is unlikely to have matched the increase in pricing over the period. In assessing the feasibility of a full buy-out, it is also important to consider the anticipated saving in operating expenses. These can be material and help remove any financial hurdle to transaction where the affordability gap is fairly small.

In comparison to scheme funding, for many schemes the cost of securing the benefits for non-pensioners may appear relatively expensive. A major reason for this typically relates to the additional allowance for growth asset out-performance included in the pre-retirement investment return assumption used to value the liabilities for funding purposes. Insurers generally assume a much lower investment return assumption, reflecting their more conservative investment approach, than is used under scheme funding for non-pensioners.

Even where the scheme has adopted a relatively low-risk funding basis and is well-funded, a material gap may still exist. For example, revaluation in deferment for members is often linked to the Consumer Price Index (CPI) and insurers are not able to allow fully in their pricing for the expected saving relative to the Retail Price Index (RPI) due to the lack of CPI hedging instruments currently available in the market. In addition, the greater uncertainties associated with the longer duration of the non-pensioner liabilities can also lead to a more prudent approach being reflected in the insurers' pricing.

Therefore, for schemes where a medium to long-term view is appropriate, there may be a preference for a strategy which targets predominately pensioner transactions, and/or a move to full buy-out once the non-pensioner population is relatively mature.

Liability management through the provision of member options can also be used by schemes to improve transaction affordability. This could either be as a result of the new pension freedoms outlined below, or using flexibilities to re-shape the pension increases in payment so they are in a form which can be insured in a more cost-effective manner. These member options could be part of a gradual de-risking approach over time, or linked directly to a transaction as was the case for the recent partial buy-out of the TRW scheme.

Insurer pricing - is a transaction affordable?

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For schemes holding a significant proportion of gilts or corporate bonds, a pensioner buy-in, whether partial or full, continues to be a potentially attractive option.

New Pension Freedoms

The introduction of the new pension flexibilities in April 2015 provides a driver for an increase in individual member transfers from DB to DC. Members transferring who are over the age of 55 now have the opportunity to access the flexibilities immediately, including the option to take their benefits fully as cash, subject to tax.

Whether the transfer option is simply incorporated into the scheme's normal retirement process and reflected in the accompanying member communications, or is taken a step further to form part of a bulk exercise, any increase in individual transfers would be expected to improve the funding position and also the potential affordability of a bulk annuity transaction.

Providing members with the option of a partial transfer, where they retain a core element of DB pension within the scheme, is also possible. While this adds complexity, it may be more attractive to members and so lead to an increased level of take-up. It may also be possible to transfer a part of the benefit which would otherwise be relatively expensive to secure with an insurer (e.g. CPI linked pension increases).

In addition, an increase in the scope for trivial commutation as a result of the changes to the limits can also help to remove members where their bulk annuity cost includes a disproportionate allowance for expenses.

For schemes holding a significant proportion of gilts or corporate bonds, a pensioner buy-in, whether partial or full, continues to be a potentially attractive option. In particular, it may be possible to use the gilt holding to purchase a pensioner buy-in at no cost, achieving full matching of the benefits for the members insured. This would remove the longevity risk as well as the interest and inflation rate risks for the liabilities covered.

“The market consensus is that a higher number of deferred pensioners will leave their DB arrangements. This will improve many schemes' funding levels and in most cases accelerate trustees' plans towards de-risking and the end game. Demand side pressure can be met in the short term by additional insurer capacity, but sustained demand will place real emphasis on trustees' 'transaction readiness'.”

PARTNERSHIP

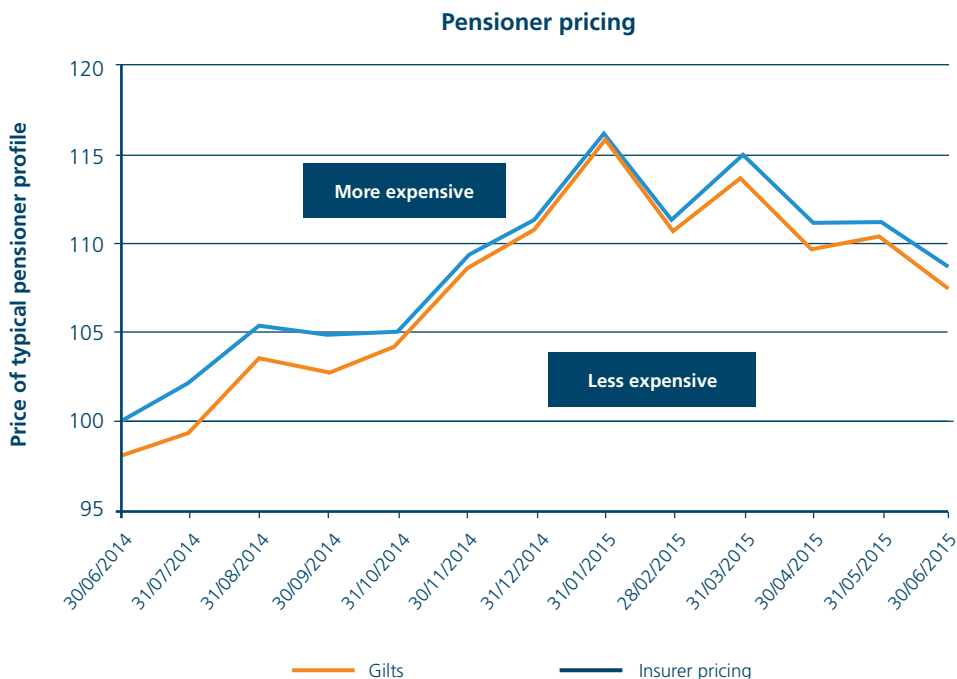
Insurer pricing - is a transaction affordable?

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In practice, the actual buy-in pricing will be influenced by the particular structure of the deal and the insurers' appetite at the time as well as the prevailing market conditions.

In carrying out a buy-in, it is important to consider the impact on the wider risk profile of the scheme and the investment strategy for the remaining members' liabilities. This is to ensure that the removal of the assets used to fund the policy does not inadvertently increase the risk profile of the scheme as a whole.

The following chart shows the movement of pensioner pricing relative to a corresponding measure of the liability based on gilt yields. Over the course of the period, the pricing has improved relative to gilts and this highlights the potential for schemes to exchange gilts for a buy-in policy at little or no additional cost. In practice, it may be possible to achieve even better pricing depending on the specific nature of the transaction and the level of competition.



Source: Barnett Waddingham model using pricing information from a range of leading insurers. In practice, any actual pricing will depend on the specific characteristics of the scheme.

In practice, the actual buy-in pricing will be influenced by the particular structure of the deal and the insurers' appetite at the time, as well as the prevailing market conditions.

Being well-prepared and in a position to transact quickly when the market conditions are right is important – not only does this allow schemes to take advantage of opportunities as they arise but also increases the engagement of the insurers and level of competitive pricing they may be willing to provide.

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Whatever approach is used to select the members to be insured, a key point is that it is done in an objective manner.

Partial pensioner buy-ins – who do you insure?

In the case of a partial pensioner buy-in, in which a buy-in transaction is completed for only part of the pensioner population, a number of different approaches have been adopted for choosing the members to be insured. Some transactions, such as the Taylor Wimpey Pension Scheme transaction with Partnership, have insured the pensioners with the largest benefits. Other transactions have insured the oldest pensioners, the youngest pensioners or even a specific tranche of the pension benefit across the entire membership. At least one transaction has been completed where the members to be insured were simply elected at random.

Therefore, a partial pensioner buy-in raises the question of which members to insure. In practice, the choice of members may depend on a number of scheme specific factors including:

- the size and profile of the pensioner liabilities
- the pricing available from the insurers and how this compares to the relevant scheme financial measures e.g. ongoing funding, the implied return of the buy-in relative to gilts etc.
- whether there is a target budget for the buy-in
- the nature and value of the assets being used to support the transaction
- the approach used by the trustees and employer to assess the value of the buy-in – for example, the resulting funding implications and the impact on the overall risk profile of the scheme

Whatever approach is used to select the members to be insured, a key point is that it is done in an objective manner to avoid any issues arising at the time of the transaction or when securing later tranches. Insurers will query the selection criteria used and it may affect their willingness to quote if they have concerns about the way the members have been chosen.

The cost implications of the buy-in will depend on the insurers' pricing and specific financial measures used by the scheme. In addition, the use of medical underwriting may also influence the preferred structure of the buy-in. Similarly, in looking at the risk profile of the scheme, the financial risks will depend on the specific assets used to fund the buy-in and the impact on the remaining investment strategy.

Partial pensioner buy-ins – who do you insure?

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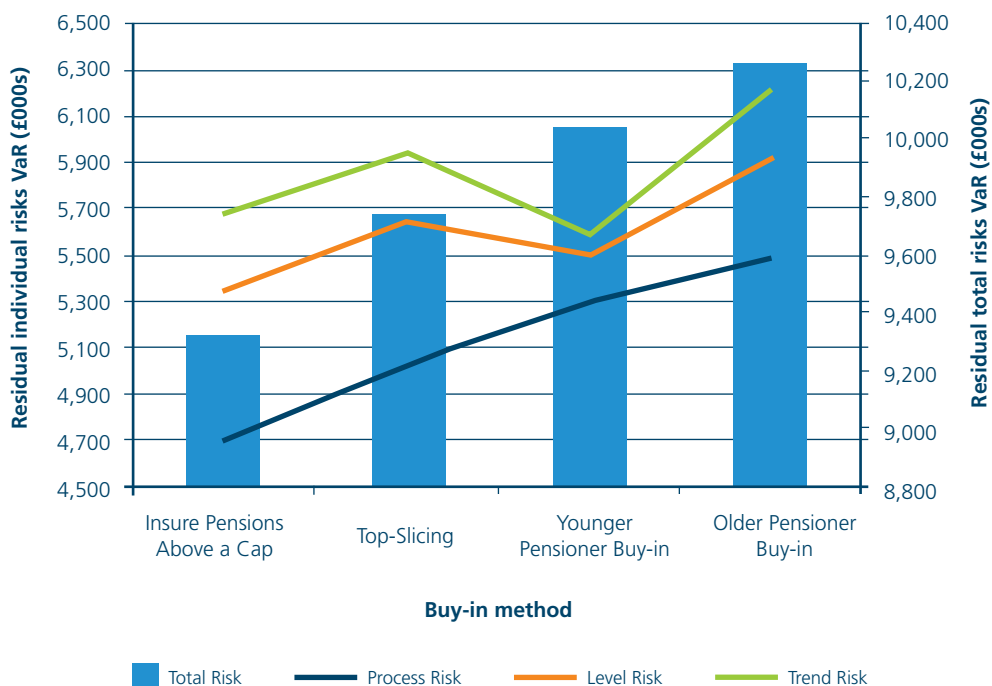
The longevity risk will always be reduced as a result of the buy-in, and this should be factored into any holistic analysis of the overall risk impact.

However, the longevity risk will always be reduced as a result of the buy-in, and this should be factored into any holistic analysis of the overall risk impact of the transaction. The degree of longevity risk removed will depend on the particular pensioners secured.

The following chart illustrates this for an example medium-sized scheme, assuming that a fixed amount of assets is available to fund the buy-in. The chart shows the value of longevity risk remaining after a buy-in has been secured. The risk measure used is the 95th percentile Value at Risk (VaR) i.e. the risk associated with a 1 in 20 probability outcome. Both the total longevity (grey bars) and the individual risk components (coloured lines) are shown.

Four options for the members covered by the buy-in are shown as follows:

- **insure pensions above a cap** – pensions above a specified level are insured
- **top-slicing** – the highest liability pensioners are insured
- **younger pensioner** – the youngest pensioners are insured
- **older pensioner** – the oldest pensioners are insured



Source: Barnett Waddingham analysis

Partial pensioner buy-ins – who do you insure?

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In addition to the financial considerations, certain practical issues also need to be taken into account when reviewing which strategy to use.

In this example, insuring the oldest members has the least reduction on the longevity risk while insuring either the highest liability members through top-slicing or all pensions above a specified amount has the greatest reduction. Whilst the impact for a particular scheme will depend on the specific membership profile, this example helps demonstrate the varying impact on longevity risk of insuring different pensioner groups.

Clearly, in addition to the financial considerations, certain practical issues also need to be taken into account when reviewing which strategy to use. For example, insuring only part of the members' benefits may limit the options or cause problems at a later stage when insuring the remainder – it would be difficult to operate a future competitive quotation process and there may be challenges in ultimately moving to buy-out.

As highlighted earlier, a further issue which may influence the choice of members insured under a partial pensioner buy-in is the use of medical underwriting. In particular, the preferred pensioner profile for the transaction may effectively be determined by targeting the group of members where the potential cost saving from using medical underwriting is anticipated to be at its greatest (e.g. highest liability members).

Are you 'transaction ready'?

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Being well-prepared will become ever more important in a market where insurers increasingly look to target their resources, and focus on those deals which are better placed to transact.

Are you 'transaction ready'?

A significant number of schemes have their eye on the bulk annuity market with a view to capitalising on future opportunities when the market conditions and insurer pricing are right. However, identifying an opportunity is only half the story. The scheme also needs to be in a suitable position to take advantage when it arises.

"We focus on whether the client has a price hurdle and has a clear idea of how to decide whether to transact or not. After that we look at how well the client team is organised, their readiness to transact and their ability to make decisions quickly."

ROTHESAY LIFE

Being well-prepared will become ever more important in a market where insurers increasingly look to target their resources, and focus on those deals which are better placed to transact. Some movements in market conditions (e.g. an increase in long-term bond yields not already priced into the market) are likely to be beneficial for the vast majority of schemes. This could lead to a material increase in demand over a relatively short period, again resulting in the insurers becoming more selective. Therefore, positioning the transaction as favourably as possible will help schemes maximise the level of insurer engagement and increase the likelihood of achieving better terms from the market.



Are you 'transaction ready'?

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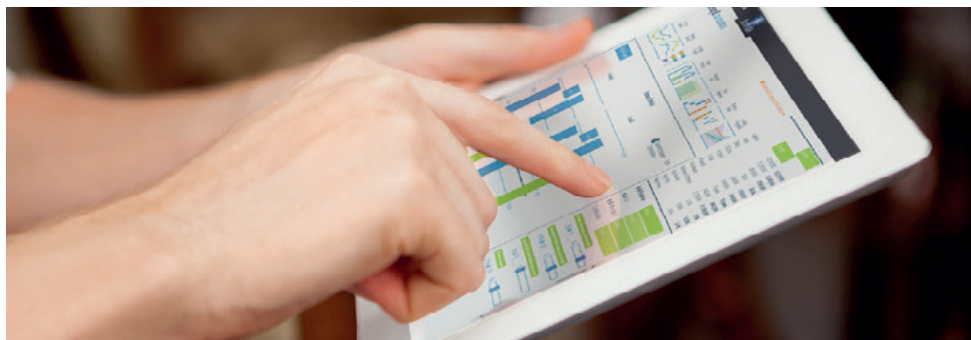
A key element in supporting an efficient transaction process is ensuring the full engagement of both the Trustees and sponsoring employer.

Affordability

In assessing the potential affordability of a transaction, as well as the impact on the scheme funding position and the need for any additional contributions, the sponsoring employer will also want to consider the accounting implications. Identifying any desired pricing criteria, for example based on the scheme funding impact or achieving a target implied return relative to gilts on the policy purchased, can help the scheme develop an objective framework for assessing the insurers' quotations.

In the lead-up to a transaction, the potential volatility in pricing means that schemes will want to monitor pricing even if they are not yet in a position to approach the market.

Barnett Waddingham's online analytical tool, *illuminate*, allows schemes to track the relative pricing of a buy-in, or buy-out, based on current pricing information we receive from a range of leading insurers in the bulk annuity market.




illuminate

Greater clarity and focus for your pension strategy

www.barnett-waddingham.co.uk/illuminate

Governance and planning

A key element in supporting an efficient transaction process is ensuring the full engagement of both the trustees and sponsoring employer. Each party needs to have a clear understanding of the potential issues involved and awareness of the intended timetable – this can be achieved by suitably tailored and targeted training from the adviser in the initial stages. From our experience, having an effective decision-making process, for example through a joint working party, can help identify any significant issues at the outset and minimise the potential for any subsequent delays in the process.

Are you 'transaction ready'?

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Poor quality data can detrimentally impact the pricing and lead to less reliable quotations, as well as affecting the level of insurer engagement.

From a practical perspective, for those companies with an overseas parent, it can also be important to ensure the appropriate engagement at a group level. Demonstrating this commitment from all the relevant parties can help to increase the level of insurer appetite for the transaction.

“We encourage trustees to agree a well designed and timely decision making process. Where trustees see a good opportunity to buy-in or buy-out, the most common cause of failure is the time taken to ratify the decision and complete the transaction. Markets move and the opportunity disappears. Experienced advisers are essential to achieve a successful outcome.”

PENSION INSURANCE CORPORATION

Data

Poor quality data can detrimentally impact the pricing and lead to less reliable quotations, as well as affecting the level of insurer engagement. The Pensions Regulator has encouraged schemes to review their data and most schemes have already completed steps to improve the quality and completeness of the information they hold. However, there is often a gap between the data quality which can be viewed as being suitable for the day to day running of the scheme and the data which is genuinely fit, or desirable, for transaction purposes.

Therefore, for most schemes there are likely to be further data cleansing actions which will help improve insurer engagement, pricing and the degree of transaction certainty.

For example, savings can be made if details of members' spouses are provided. This is especially the case for any larger liability members where the insurers will typically take a relatively prudent approach in the absence of any data. Full postcode information is important for insurers in carrying out their longevity assessments. Completing the reconciliation exercise for members' Guaranteed Minimum Pensions (GMPs) in advance can also help save time later in the process, particularly when determining an appropriate approach for the sex equalisation of the GMPs.

As data cleansing takes time, it is important to plan and prioritise any actions. This will help identify any steps which are needed before approaching the market and also those steps which can be more efficiently completed in tandem with the quotation process.

Are you 'transaction ready'?

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it is often appropriate to refine the asset strategy as the process progresses and the choice of the preferred provider becomes clearer.

Benefits

Ensuring that the benefits specified to the insurer are definitive and clear is a critical part of the transaction process. While this may seem like a relatively straightforward exercise, a detailed legal review of the benefit specification in conjunction with the scheme rules (both current and any applicable historical versions) can often surface issues which need to be addressed. Past complications due to equalisation or inconsistencies between the benefits under the rules and actual administration practice are not uncommon. Reviewing the benefits in a timely manner can therefore save time later on and avoid any corrections after insurer quotations have been provided.

The approach taken for any pensions which have complex increases, or which may be relatively expensive to insure, also needs to be considered. In addition to the potential options for re-shaping the benefits discussed earlier, schemes could choose to insure a variation of the scheme benefits (e.g. RPI linked increases rather than CPI linked increases). This may offer a higher expected value with a view to potentially adjusting the terms at a later date to reflect the members' individual entitlements. Advance planning and exploring the options early can lead to more cost effective solutions for schemes.

Investment strategy

For any transaction, considering the scheme's investment strategy is also important. This applies for both the assets which are used to meet the premium and also any remaining assets in the case of a partial transaction.

For the assets earmarked to fund the premium, reducing the level of potential volatility relative to the insurers' pricing by more closely matching the insurers' underlying investment approach can help avoid a transaction becoming unaffordable. Depending on the size of the transaction, holding assets which are more likely to be acceptable to the insurers can also reduce the overall transaction costs through in-specie asset transfers, even if this is only used to meet part of the premium. As the insurers' specific asset preferences differ, it is often appropriate to refine the asset strategy as the process progresses and the choice of the preferred provider becomes clearer.

For any assets where an in-specie transfer is not possible, another issue for schemes is the potential liquidity and timescale for realising those holdings. Complex derivatives or property assets may be difficult to unwind at short notice so it is important to consider these sufficiently in advance. Even if assets are fairly liquid, it can still take a reasonable amount of time to disinvest the assets from an investment manager and transfer them to the insurer. Agreeing a pricing mechanism with the insurer which recognises this as far as possible can help to lock into pricing and mitigate any potential adverse impact from market movements.

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This attractive level of pricing has been aided by the strong appetite of the specialist insurers.

Medical underwriting

The medically underwritten bulk annuity market has grown dramatically over the last couple of years since the first transaction was carried out at the end of 2012. The value of transactions carried out by the leading specialist providers, Just Retirement and Partnership, has jumped from approximately £90m in 2013 to around £700m in 2014. This rapid increase reflects the competitive pricing and significant savings which have been achieved by adopting the medically underwritten approach – with pricing being around, or even below, a scheme’s funding reserve in some cases.

“There is no question that medical underwriting has increased affordability for the small-medium sized schemes, through both the effect of the underwriting reducing premium levels when compared to traditional pricing, but also through increased competition. As new entrants come into the market we expect to see the market for medically underwritten bulk annuities grow and evolve.

We also expect demand to increase with the very largest schemes looking to utilise medical underwriting via top-slicing exercises.”

JUST RETIREMENT

Used in conjunction with a gilt exchange for the payment of the premium, medically underwritten transactions have been completed where the implied return on the policy has been significantly in excess of gilt yields, and so the overall expected return on the scheme’s assets has actually increased as a result. This attractive level of pricing has been aided by the strong appetite of the specialist insurers looking to develop the market and establish their presence.

For their assessment of life expectancy, a traditional insurer will usually consider indicative rating factors for the members such as pension amount, occupation and postcode, in addition to age and gender. Medical underwriting works by taking the assessment a step further by making allowance for the specific health and lifestyle characteristics of the members covered by the transaction. The presence of any medical condition or lifestyle factor can have a significant impact for an individual’s liability as illustrated below.



Source: Partnership/Just Retirement

Simplified ranges shown for illustration purposes only, actual premium adjustments for individuals dependant on range of factors

Medical underwriting

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The emergence of ‘top-slicing’ has opened up the potential for much larger schemes and transaction sizes.

While the presence, and the resulting impact, of any health or lifestyle issues will depend on each specific case, gathering this additional information will generally reduce the degree of uncertainty – helping to improve pricing by lowering any insurer margins for prudence.

Medically underwritten transactions were initially targeted at relatively small schemes (of the order of 300-400 members). However the emergence of ‘top-slicing’ has opened up the potential for much larger schemes and transaction sizes. This was demonstrated by the £206m pensioner buy-in with the Taylor Wimpey Pension Scheme, a multi-billion pound scheme, announced by Partnership in December 2014.

Top-slicing

Top-slicing works by focussing on the pensioners with the largest liabilities in the scheme, where the impact of medical underwriting is likely to be at its greatest.

For most schemes, these members with the largest pensions will typically represent a disproportionately large share of the total liability resulting in a potential concentration of longevity risk i.e. if these members live longer than expected then the liabilities can increase significantly.

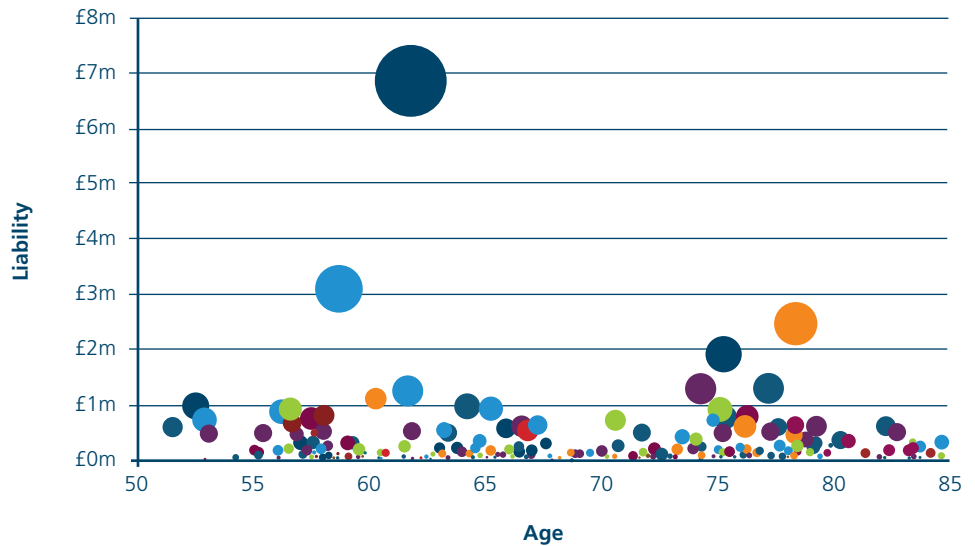
Understanding the distribution of longevity risk, and any concentration, can be an important factor in determining the preferred structure and coverage for a partial buy-in.

Medical underwriting

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Top-slicing can be a cost effective way of securing these members and removing their associated longevity concentration risk.

Individual member liabilities



Source: sample scheme

The chart above illustrates that relatively few members can often represent a significant part of the total liability. A medical underwritten buy-in can be particularly effective when insuring these high liability members, as traditional insurers typically take a relatively prudent approach in their pricing for these individuals.

A meaningful saving can be achieved for an high liability member even if the medical or lifestyle issue is only fairly minor. Simply gathering the information will tend to reduce the level of uncertainty and so help to improve the pricing.

Top-slicing can be a cost effective way of securing these members and removing their associated longevity concentration risk.

Medical underwriting

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Our experience has been that a good communication process can lead to very high levels of member engagement, with positive response rates in excess of 90%.

In implementing a medically underwritten approach, the trustees should look to maximise the level of member engagement in a way which recognises the potential sensitivity of the medical information being gathered. Our experience has been that a good communication process can lead to very high levels of member engagement, with positive response rates in excess of 90%.

In practice, there are three ways of obtaining the information which can be used in combination – an initial short member questionnaire, telephone interviews and individual GP reports.

Overview of medical underwriting process

Member communication

Members introduced to process and issued medical questionnaire (if applicable).
Permissions sought for telephone interviews/GP reports.



Data gathering

Telephone interviews/GP reports obtained.
Focus on members with higher liabilities or where potential issues identified in questionnaire.



Information sharing

Assuming competitive process, access to central data hub provided.
Data supplied in common format to each insurer.



Medical underwriting

Assessment of individual member longevity using medical information.
Transaction pricing reflecting specific characteristics of scheme members.



Medical underwriting case study

Background

- De-risking opportunity identified for Renold Pension Scheme, the UK DB scheme of Renold plc, an international engineering group.
- Medically underwritten pensioner buy-in for the highest pensioners representing about 25% of the total pensioner liability.
- Part of overall de-risking path and funded from existing index-linked gilt holdings.

Process

- Competitive tender process involving all the active providers in market.
- Clearly defined information gathering process and timetable at outset.
- Effective communication leading to very high level of member engagement – over 90% positive response rate.

Outcome

- **Very competitive level of pricing resulting in no additional cost on scheme funding basis, and over 10% lower than traditional approach.**
- **Implied return on policy materially above gilt yields.**
- **Full liability matching and risk removal in respect of members covered, including removal of concentration of longevity risk.**

“The company considers this transaction to be an important move in helping to manage its legacy pension obligations and the impact of volatility on its balance sheet. Attractive pricing through the use of medical underwriting allowed us to secure a material proportion of the pensioner liabilities at no additional cost, thanks to the proactive advice and commitment of Barnett Waddingham”

Brian Tenner,
Finance Director, Renold plc

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Alongside the pension freedoms, Solvency II (SII) is one of the biggest topics in the insurance industry at the moment.

Solvency II for insurers

Alongside the pension freedoms, Solvency II (SII) is one of the biggest topics in the insurance industry at the moment. These are new EU regulations that govern the way insurers are funded and the processes they have to put in place to mitigate the risks they face and are due to take effect from 1 January 2016.

For annuity providers, the recent focus has been on the ‘matching adjustment’. This is a concession to the SII regulations which allows the insurers to include a portion of the corporate bond risk premium in their investment return assumption used for their liability valuations.

The insurers need to apply to use the matching adjustment and all of the main bulk annuity providers have been spending the last few months devoting considerable resources to this issue. Not receiving the desired approvals could be detrimental to the insurers’ ability to price competitively and their relative market positioning.

Central to the approval is the certainty of an insurer’s asset cashflows. This can pose some difficulties for the more non-traditional asset classes and in some cases it is likely that certain insurers may need to use fairly complex structures (such as special purpose vehicles and/or securitisations) to ensure they are eligible for the matching adjustment.

In tandem with the matching adjustment, many firms are also applying to use an ‘internal model’. This allows them to value their liabilities in a way specific to their own business, rather than relying on the standard formula provided in the regulations.

Decisions on both matching adjustment applications and internal models are not likely to be finalised until shortly before the end of the year, creating some uncertainties for insurers in the meantime. From a scheme’s perspective, this means that there likely to be some varying impacts on the insurers’ respective appetites and pricing in the shorter-term. It is therefore important to maximise the level of competition within the quotation process and to understand any risks associated with a particular provider.

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We expect to see more transactions of this type announced in 2015 – although we suspect this deal structure will continue to be the preserve of larger schemes due to the ongoing costs.

Longevity swaps

During 2014, significant advances were made in the longevity swap market with more risk written than ever before and new models for laying off the risk being proven.

Recent important transactions include the AXA UK Group Pension Scheme and the Scottish Power Pension Scheme transferring the longevity risk on £2.8bn and £2bn of liabilities respectively, while the Merchant Navy Officers Pension Fund did the same for £1.5bn of liabilities. In 2014, we also saw the largest transaction in the history of the longevity swap market: the BT Pension Scheme's £16bn swap with the Prudential Insurance Company of America, covering 191,000 pensioner members.

Both the BT transaction and the Merchant Navy Officers used a model trialled by Aviva's transaction for their own staff pension scheme last year. Under this structure the pension scheme was able to access reinsurers directly by setting up and passing the risk on to their own subsidiary insurance company, so avoiding the transactional costs of passing through an intermediary. The likely savings from this approach could be as much as 2% of the value of liabilities, less the annual operating costs of the subsidiary.

We expect to see more transactions of this type announced in 2015 – although we suspect this deal structure will continue to be the preserve of larger schemes due to the ongoing costs. Smaller schemes can still access the reinsurance market via an intermediary and will look to do so as the longevity market becomes a better known route to lay off risk for schemes on longer-term journeys to run-off or wind-up.

However, all is not over from a risk perspective once a swap is written – on the contrary, in many cases the governance challenges are just beginning. In particular, it is important to ensure that scheme administrators have adequate systems in place to report the information required by the reinsurance counterparty. Trustees will often benefit from independent actuarial support to assess the quality and timeliness of reporting and whether the resulting mortality experience is reasonable.

Providers of bulk annuity insurance have also accessed the market in the past year. In the final quarter of 2014 alone, transactions were undertaken by Rothesay Life, PIC and Legal & General to pass on the risk from over £4bn of bulk annuity business previously written.

There has been speculation within the industry over potential limits on appetite from counterparties for longevity risk. Our view is that such fears are exaggerated at present and that there is enough appetite to support transactions for several years to come, although as highlighted earlier this may become an issue over the longer-term. We are aware of several reinsurers who have recently increased the capital available for longevity transactions. Indeed, some of the transaction sizes above could not have been written in the smaller market that existed two or three years ago.

Insurer financial strength

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Barnett Waddingham's financial review service can help trustees and employers make an informed decision and form part of an appropriate due diligence process.

Insurer financial strength

While entering into a bulk annuity contract is essentially aimed at de-risking the scheme, it does introduce a new counterparty risk in the form of the insurer and their ongoing ability to meet the benefits secured.

Therefore, an important element of the process for the trustees and sponsoring employer will be to consider the financial strength and stability of the insurer. Part of this will involve gaining an understanding of the regulatory regime governing insurers and the safeguards it introduces.

Insurers are required to satisfy stringent capital requirements which are enforced by the Prudential Regulation Authority (PRA). These are known as Pillar 1 which is made public and Pillar 2 which is not. The Pillar 2 test requires that the insurer will be able to survive extreme events that are considered to occur with a 1 in 200 probability in a year. The PRA reviews the insurers' level of capital regularly and may take action if they perceive these to be inadequate.

In the unlikely event that an insurer may default, attempts would be made initially by the regulatory authorities to transfer the liabilities to another provider. If this is not possible, the Financial Services Compensation Scheme (FSCS) would apply to the bulk annuity policies, the amount covered under the FSCS having recently increased from 90% to 100% from July 2015. However, the FSCS has not been seriously tested on a large scale, and so its ability to cope effectively with the failure of a major insurer is not known in practice.

The statutory safeguards can provide considerable comfort and to date no bulk annuity insurer has become insolvent. However, there have been cases where insurers have made business decisions not to continue in the market, and have transferred their pension liabilities to another insurer. For example, Paternoster and MetLife Assurance both transferred their liabilities to Rothesay Life, and Lucida transferred their liabilities to Legal & General. Although such transfers are carefully reviewed to ensure they are in the best interests of the members, they can still raise some issues for the members and trustees.

Barnett Waddingham's financial review service can help trustees and employers make an informed decision and form part of an appropriate due diligence process. Identifying and understanding the key factors can influence the choice of insurer, especially where any pricing differences or drivers are relatively small.



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