

# Preparation is the key to success

De-risking report 2019

# Our credentials



## Size and volume

- Experienced adviser on transactions ranging in size from £2 million to £16 billion
- Advised on the first buy-in transaction in 1999. We have subsequently advised this client on four further deals
- A team which has experience of over 800 transactions, including leading over 30 buy-ins and buyouts in 2018
- Advised more than 20 schemes that have put in place multiple buy-ins, using both umbrella contracts and open market approaches
- Adviser to insurers on annuity portfolio sale transactions including the largest pension risk transfer deal ever, the Prudential to Rothesay Life backbook
- Advised on over half of all public domain longevity swaps including the largest longevity risk transfer ever, the BT Pension Scheme longevity swap, and three of the four longevity swaps completed in 2018



## Innovation

- We have a history of innovation and embracing new ideas. For example we were the lead adviser in respect of:
  - The first collateralised buy-in
  - The first all-risks buyout
  - The first software tracking system to track live insurer pricing
  - The first umbrella contract for repeat buy-in transactions
  - The first streamlined longevity swap with Legal & General
  - The first novation of a longevity swap
- Our Longevity Direct offering was the first ready-made vehicle for pension schemes to access the longevity reinsurance market
- 135 pension schemes and six insurers/reinsurers use Willis Towers Watson's market-leading Postcode Mortality Tool



## Client-focused solutions

- Streamlined approach which includes pre-negotiated contract terms for cost efficient and quick transactions
- Strong relationships with the provider market, leading to the best solutions for our clients
- The only adviser to have led public domain transactions using all of the available structures
- Longevity risk is integrated within the investment risk framework to enable active decisions
- Settlement is a key part of our fiduciary investment offering and at the heart of our strategic advice



# Welcome

Welcome to Willis Towers Watson's 2019 de-risking report. 2019 is both the 10th anniversary of the first longevity swap and the 20th anniversary of the first buy-ins. Will we see more innovation in 2019 — perhaps the first deal for a commercial consolidator? In this report, our experts look back at learnings from 2018 and predict the key themes in the longevity hedging and bulk annuity market over the next year.



2017 ended on a particularly strong note and this continued in 2018. 2018 saw unprecedented bulk annuity transactions activity, with in excess of £20 billion of bulk annuities transacted, including the biggest ever deal. We therefore start this report with Tom Ashworth considering some of the themes that contributed to

this record-breaking year on page 2. The attractive pricing driving this surge in demand from pension schemes is certainly an opportunity for most schemes, although it is also creating challenges for others, particularly as, due to resource constraints, insurers had to be more selective on the quotations that they produced. Matt Wiberg considers what this means for schemes targeting smaller transactions on page 10.

The busyness of the market has created some opportunities for new entrants and on page 12 we share an interview we ran with Justin Grainger from Phoenix Life. Phoenix completed three buy-ins in 2018 for Willis Towers Watson clients, and Justin will share his perspective on this market and Phoenix's aspirations for the future.

One of the drivers of the busy market is trustees recognising that longevity risk is now one of the largest risks that their scheme is running, and therefore they are seeking to transfer it. On page 5, Katherine Gilder studies the sources of longevity risk and how your views on it should drive your action plan.

As well as a record-breaking amount of pension scheme transactions, 2018 also saw the largest “backbook” deal to date when Willis Towers Watson advised Prudential on the sale of £12 billion of its historic annuity book to Rothesay Life. Gemma Millington considers on page 8 what pension schemes can learn from backbook deals.

In another interesting development for the settlement market, 2018 also saw the creation of commercial consolidators. Suzanne Vaughan considers some of the alternative settlement options to traditional buyout that pension schemes now have on page 14.

Finally, on page 16, Will Griffiths shares his views on what we might expect from the bulk annuity and longevity swap markets in 2019.

At Willis Towers Watson, our team brings together experience and expertise across pension consulting, insurance, liability management exercises and project management to help our clients find the right solutions for them. We work alongside a wide range of clients as their strategic de-risking adviser, helping them to identify and plan their end-game strategy, and the steps they can take along the way.

We would welcome the chance to discuss further with you how you can take advantage of the opportunities in this market for your scheme.

**Ian Aley**  
Head of Transactions

# Looking back at 2018



Tom Ashworth

2018 was widely tipped to be a breakthrough year in the bulk annuity and longevity hedging market and it's fair to say it didn't disappoint, with the busiest year to date in the bulk annuity market and further evolution at the smaller end of the longevity hedging market. Tom Ashworth considers the trends in 2018 and what this could mean for 2019.

## The bulk annuity market

Starting with the bulk annuity market, 2018 broke the mould, smashing records throughout the year. As can be seen in *Figure 1*, bulk annuity deals between insurers and pension schemes topped £20 billion for the year, well ahead of the previous record of £13.2 billion in 2014. Much of this activity includes the return of the "mega deal". Whilst 2017 was a relatively quiet year without a £1 billion+ trade, in 2018 we saw:

- four bulk annuities of over £1 billion;
- the largest bulk annuity transaction to date, the £4.4 billion deal between Legal & General and the Airways Pension Scheme;
- four providers write their largest ever bulk annuity;
- Phoenix completing their first transactions with external schemes; and
- four providers insuring more liabilities over the course of a year than ever before.

If that wasn't enough, 2018 opened with Rothesay Life securing £12 billion of Prudential's historic annuity book. To provide some context, this transaction alone took up

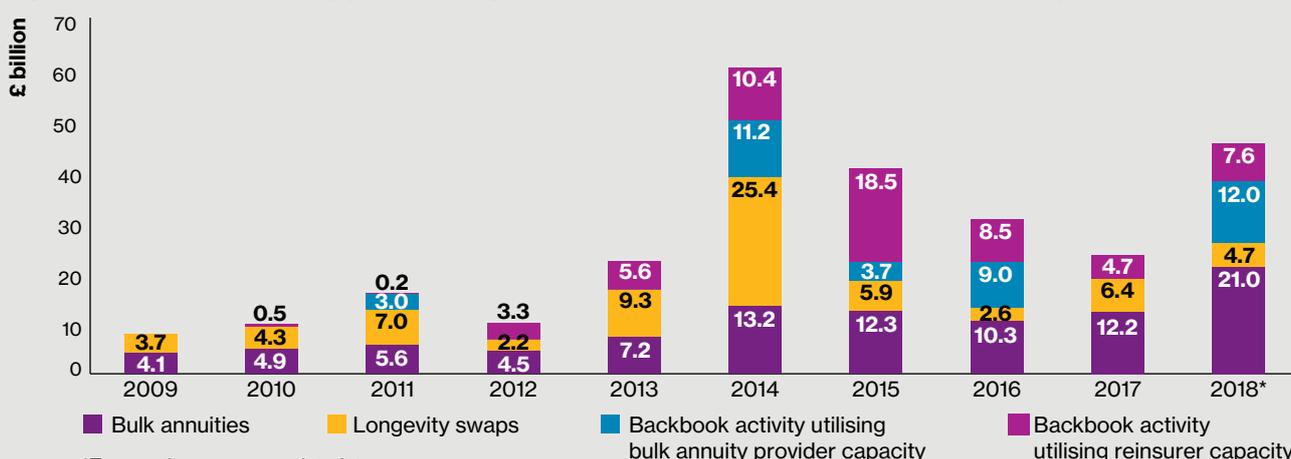
capacity within the market at a similar level to bulk annuity deals written between insurers and pension schemes in each of the past four years.

For the first time ever demand from pension schemes exceeded supply from insurers. A trend in the market saw some insurers becoming much more selective on deals that they chose to quote on. With limited capital and human resources, insurers typically base their decision on:

- (i) the likelihood of the deal transacting; and
- (ii) the chances that, if it does transact, they will be the selected insurer.

The good news for pension schemes is that insurers' perception of (i) is within the scheme's control and if they focus on putting their best foot forward with the market, with a clear project plan and objectives, a trustee and sponsor decision-making framework in place and appoint an experienced adviser, then the insurers will be keen to quote. Recent insurer feedback indicated that the proportion of quotation requests that they turned down in 2018 had increased by over 50% from 2017. Furthermore

Figure 1. Volumes of business by year (including bulk annuity provider and reinsurer backbooks in the public domain)



the insurer also noted that they are less likely to turn down a Willis Towers Watson deal (as we have a very good track record of completion) and also that they hadn't declined to quote on any requests from schemes that had previously completed a buy-in, as this is a great indicator to the market of the likelihood of a future deal transacting.

**With such high demand in the bulk annuity market, how did pricing evolve over 2018?**

Pricing level is one of the reasons for the demand in the bulk annuity market in 2018 – pricing in 2017 and the start of 2018 was consistently attractive, and we haven't seen such consistency for a number of years. This helped to provide a healthy pipeline of schemes looking to trade, but rather than temper pricing, with good asset availability and eight market participants competing for deals, we actually saw pricing improve further still over the first of the half year, as shown in *Figure 2*.

One area where pricing particularly improved in 2018 was for non-pensioners and this was one of the drivers for the increased prevalence of buyout deals.

In the last few months of the year, pricing from some providers did worsen marginally, whilst across others there remained pockets of strong pricing up to the year-end for nimble schemes to take advantage of. Where we did see pricing soften from selected providers, this was partly a consequence of their successes earlier in the

year – these deals diminished their appetite later in the year and particularly their 'warehoused' assets to back bulk annuities, resulting in a depleted stock of high yielding assets available to match pricing from earlier. With 2019 now upon us, this has fallen away and we have seen pricing from these providers improve again.

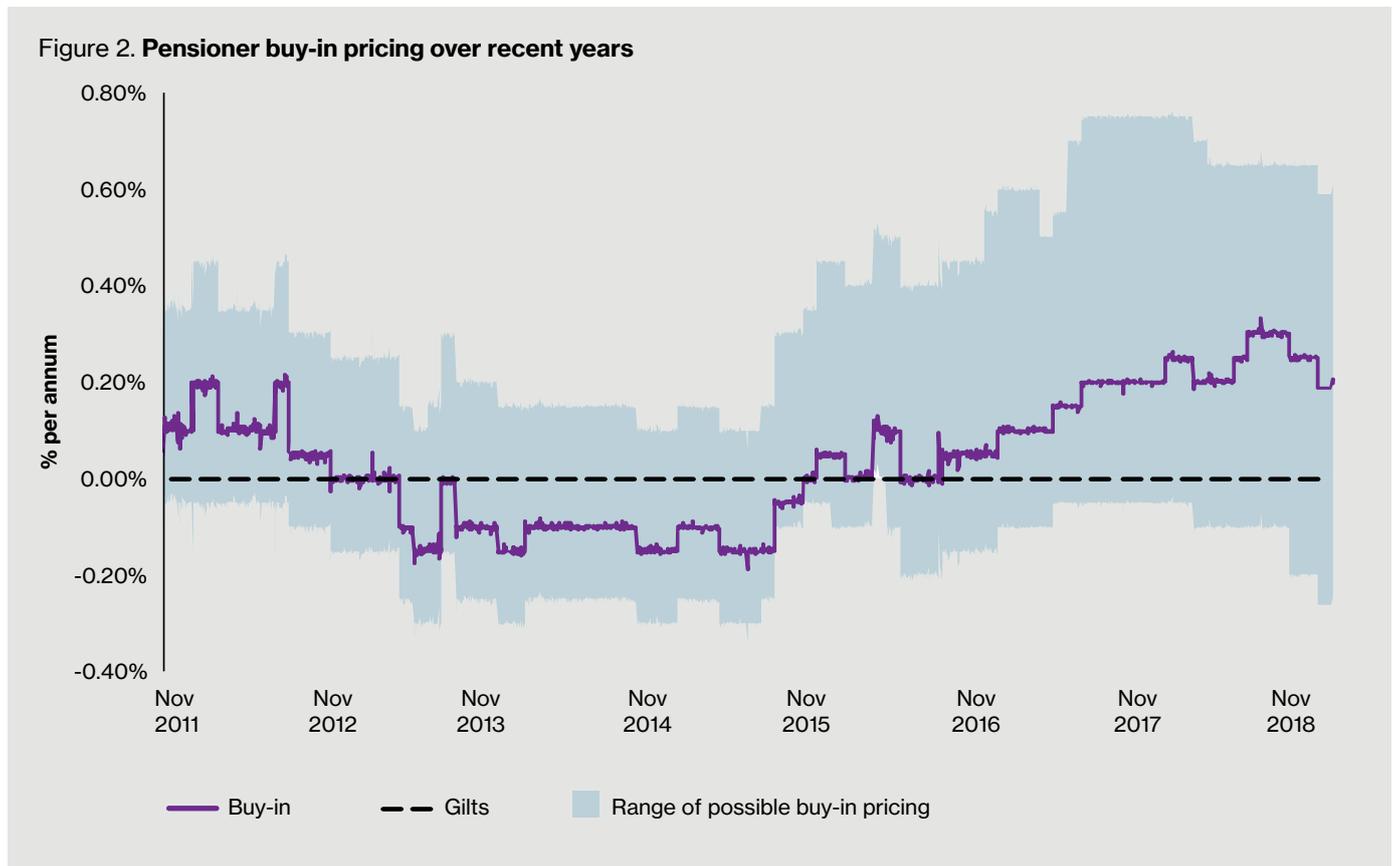
Because of this, in 2018 we observed:

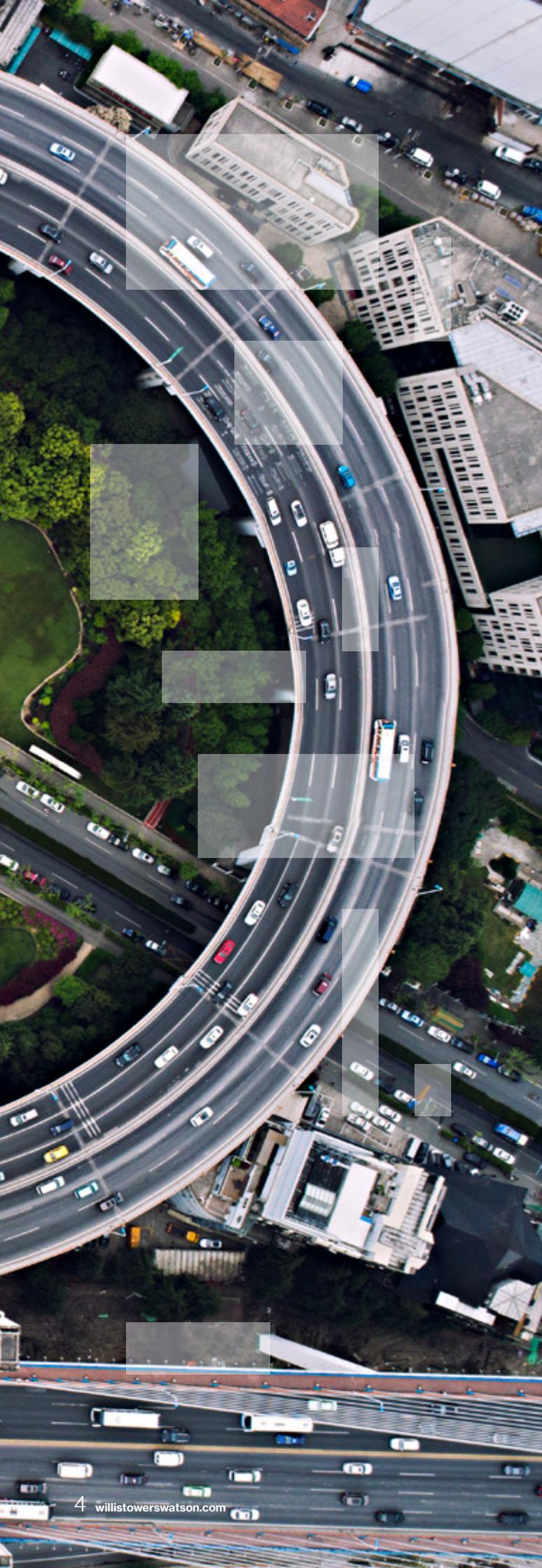
- a market which so often sees a slower start to the year followed by a rush at year end instead had some insurers meeting their new business targets much earlier in the year and becoming much more selective in the autumn months.
- a market which has historically had peaks and troughs has instead levelled out, with a steady flow of business throughout the year, with many in the industry commenting it has plateaued at a level that was formerly a 'peak'.

**2018: The return to fashion of the buyout**

Whilst the sheer volume of business in the market caught the headlines in 2018, what flew under the radar somewhat was the increase in full scheme buyouts. This was driven by two factors – insurer pricing and scheme funding levels.

Increased innovation in longer duration and CPI-linked assets has particularly benefited non-pensioner pricing, so often the pricing obstacle to a full buyout. A further maturing





of the longevity hedging market, with reinsurers becoming more comfortable hedging non-pensioner longevity risk from insurers, has further enhanced pricing for schemes. This risk (in part) is being passed through to the reinsurance market, thereby reducing the capital requirements to write the business, and ultimately reducing pricing.

These developments have come at a time when schemes' funding levels have improved, and progress along the journey to buyout has been accelerated by strong equity performance in recent years and recent mortality trends. Member experience has also played a part in this and over 2018 we have seen an increase in member option exercises, particularly from those pension schemes that are well-funded (say, 85% plus) against their buyout or solvency measure. These schemes have used the well-trodden exercises such as a Pension Increase Exchange, or Retirement Transfer Option to nudge closer to a level where they are within striking distance of buyout, or when viewed another way, just a small amount of pricing volatility away from hitting their ultimate target and securing their scheme in the insurance market.

### What has happened in the longevity hedging market in 2018?

Whilst the longevity hedging market hasn't gained the same news coverage that we've seen in relation to the bulk annuity market, we have certainly seen evolution, if not revolution within this market. There were four longevity swaps completed in 2018, allowing schemes to lock into terms reflecting the recent downwards trends in longevity expectations:

- Two continued the use of Captive Insurers and used Willis Towers Watson's ready-made cell, Longevity Direct
- Zurich completed an intermediated longevity swap with National Grid covering c£2 billion of pensioner liabilities, marking Zurich's entry to the market for larger transactions; and
- Legal & General completed their first streamlined longevity insurance contract covering c£300 million of liabilities. Our article on page 10 explains the streamlined offerings now in place. The increased flow of longevity risk from insurers to reinsurers has enabled longevity swaps covering as little as £100 million of pensioner liabilities to be completed – hedges at this level were unheard of in the longevity swap market just a few years ago.

So, in summary, 2018 was quite the year in the longevity hedging and bulk annuity markets, with records broken and boundaries pushed. It was, though, a year that has created more questions for this market going forwards – **is this volume of business here to stay? If so, will smaller schemes find market traction more difficult? And how will this interact with the consolidator market? Read on to hear from our experts.**

# Spotlight on: Longevity risk



Katherine Gilder

Increasingly, defined benefit (DB) pension schemes have developed and implemented a de-risking journey towards buy-in or self-sufficiency. Reducing investment risk has been the main focus in this journey for many schemes to date. But as this reduces over time, managing longevity risk becomes increasingly important. With this in mind, Katherine Gilder considers what longevity risk is, and when and how trustees and sponsors can manage this risk.

## What is longevity risk?

Longevity risk comprises five key components:

- 1 Base table risk** or the risk that the assessment of the membership's mortality today is incorrect – this is particularly relevant to smaller groups.
- 2 Trend risk** or the risk that, even with all of the information available to us at a point in time, mortality rates do not change as assumed – this is the main concern for larger schemes.
- 3 Idiosyncratic risk** or the risk that, even if average current and future mortality rates were known with certainty, individual members live longer than expected. In larger schemes, averaging tends to remove this risk, although even then some schemes could have significant idiosyncratic risk for certain groups. This is therefore likely to be a concern for small schemes or those demonstrating a concentration of risk in high income individuals.
- 4 Model risk** or the risk that models being used to quantify longevity risk are not appropriate.
- 5 Market risk** or the risk that the market price, in the case of longevity risk, of insuring the risk increases.

## Why is longevity risk important for trustees and sponsors?

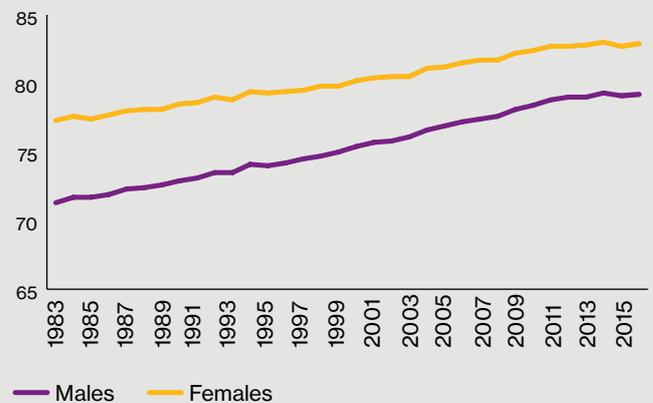
Whilst most schemes have seen reductions in life expectancy reducing their liabilities at their most recent valuation, it shouldn't be forgotten that, prior to that, increases in life expectancy had added around 10% to pension scheme liabilities in the previous decade. Schemes have now adjusted their longevity assumptions to reflect

the past trends but what if, as in the past, the latest assumptions are also wrong? Every additional year of life expectancy adds 4% to pension scheme liabilities.

## Should you hedge risk now or in the future?

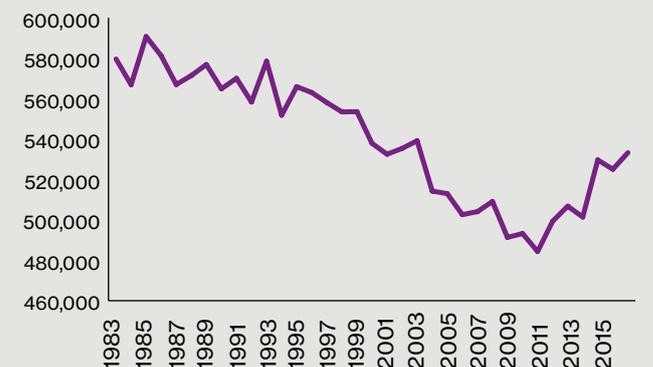
Figure 3 shows that the UK has seen significant improvements in longevity over the past century but more recently improvements have stalled and death numbers have increased.

Figure 3. Rapid increases in life expectancy since the 1980s



Source: Office of National Statistics

Rapid decline in annual death numbers since the 1980s



Source: ONS, England and Wales death registrations

So, what might happen in the future? Some consider that longevity will continue to improve at its current rate due to innovation in medical science, whilst others consider that it will not continue at its current rate due to biochemical limits on our lifespan and may even deteriorate due to an increase in the incidence of obesity. It's also worth noting that UK population experience may not be fully or even partially reflected in the experience of DB pension schemes, whose members are in general older and relatively better off in retirement.

In light of this uncertainty, trustees and sponsors should consider whether, and when, to hedge longevity risk. Trustees and sponsors should make a conscious decision about retaining versus hedging longevity risk, as they would with investment risks. The following 'belief statements' may help you to clarify your current situation to help decide when to start hedging longevity risk.

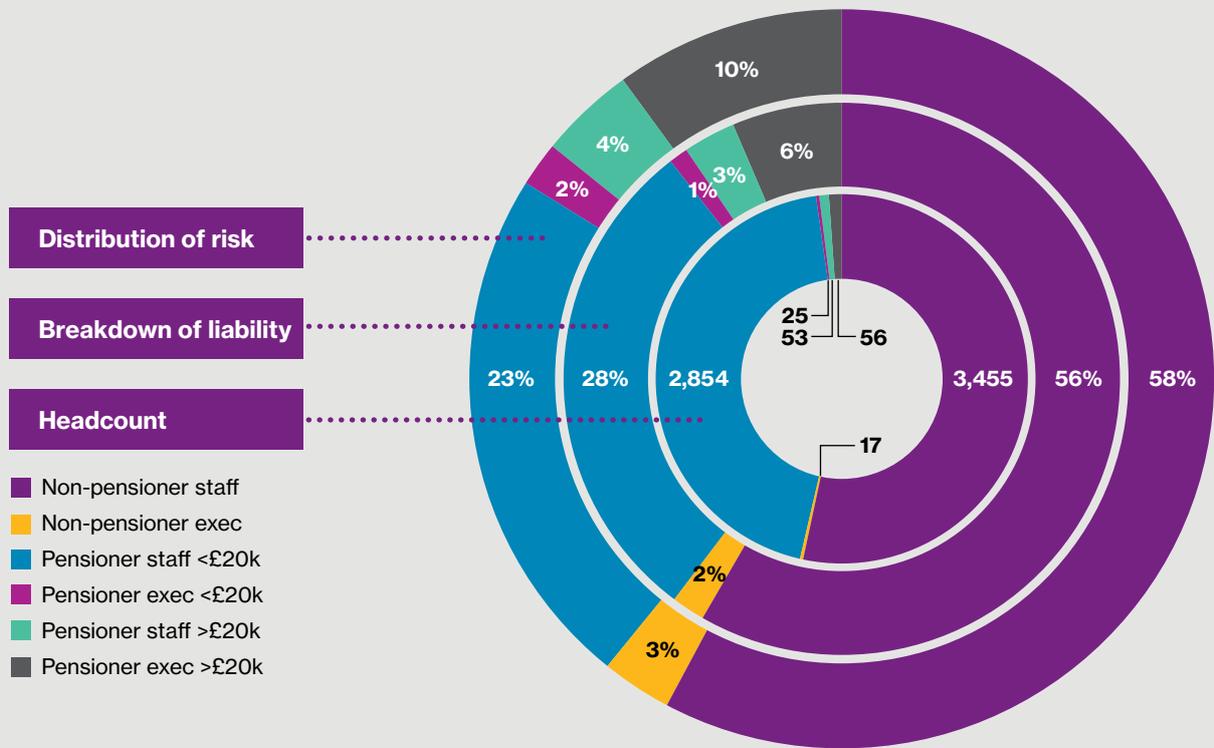
Considering longevity hedging is consistent with the following views:	Deferring longevity hedging is consistent with the following views:
<ul style="list-style-type: none"> <li>▪ Hedging longevity risk is a key feature of our overall journey plan, so it will be hedged eventually and is therefore a question of timing</li> </ul>	<ul style="list-style-type: none"> <li>▪ The scheme will not hedge longevity risk for many decades</li> </ul>
<ul style="list-style-type: none"> <li>▪ Longevity hedging will become more expensive over time due to supply and demand imbalances, or an absence of a view around future pricing</li> </ul>	<ul style="list-style-type: none"> <li>▪ The risk premium for accepting longevity risk will become cheaper to insure in the future</li> </ul>
<ul style="list-style-type: none"> <li>▪ There has been, or will be, a funding release at the next valuation due to the recent mortality trends which could be used to fund the cost of longevity hedging</li> </ul>	<ul style="list-style-type: none"> <li>▪ Longevity risk is not a significant risk now or the cost of hedging is disproportionate to the risk</li> </ul>
<ul style="list-style-type: none"> <li>▪ Longevity risk is a significant risk now and there are immediate risk management benefits</li> </ul>	<ul style="list-style-type: none"> <li>▪ The scheme does not anticipate de-risking, so longevity hedging can be deferred</li> </ul>
<ul style="list-style-type: none"> <li>▪ Longevity risk will become material over time and it is sensible to start building a hedge now</li> </ul>	<ul style="list-style-type: none"> <li>▪ There are other reasons not to hedge (for example, sponsor views and impact on accounts)</li> </ul>
<ul style="list-style-type: none"> <li>▪ There may be wider benefits (for example, sponsor and investors may see this as good risk management)</li> </ul>	<ul style="list-style-type: none"> <li>▪ The governance and implementation costs are too high to justify starting now</li> </ul>
<ul style="list-style-type: none"> <li>▪ Longevity risk represents a single concentrated risk which is only there due to the liabilities of the scheme (you would not choose to add this to a portfolio if it was not there already)</li> </ul>	<ul style="list-style-type: none"> <li>▪ Market innovation will make longevity hedging easier in future</li> </ul>
<ul style="list-style-type: none"> <li>▪ The risk saving is worth the governance and associated costs</li> </ul>	<ul style="list-style-type: none"> <li>▪ Recent mortality data implies the price of hedging longevity will be cheaper in future</li> </ul>
<ul style="list-style-type: none"> <li>▪ Recent mortality data showing a recent slow in improvements might give a window of opportunity to secure favourable pricing before trends reverse</li> </ul>	

## What steps should be taken to start the longevity hedging process?

Firstly, understand the mortality risk attributable to different membership categories (as shown in *Figure 4*) to enable consideration of the liabilities to hedge. Some pension schemes have considered the market options for insuring deferred longevity risk and have found the cost unattractive. But the increase in the number of transfers out of DB pension schemes over the last few years has meant that longevity risk for non-pensioners is naturally being removed.

Therefore, the consideration will largely be in relation to all or a part of your pensioners. It will be important to understand any concentrations of risk in your populations, what level of risk will be removed and whether a buy-in or longevity swap fits better with your journey plan, so that you can decide your preferred strategy. An initial feasibility stage may be appropriate – this typically includes indicative market pricing, considering the funding and accounting implications, and general training on the options available.

Figure 4. Longevity risk attributable to different membership categories



# What can pension schemes learn from insurer backbook deals?



Gemma Millington

Against the backdrop of an ever-shifting political environment, the UK bulk annuity market has been more than resilient to external market events as records tumbled in 2018. Not only have overall annuity volumes reached lofty new heights, but we have seen two deals enter the record books as the largest ever pension risk transfer. Two, largest? An oxymoron... perhaps, but true... word of honour. For whilst the bulk annuity providers sit alone as buyers of UK pension risk, there are two increasingly willing sellers: pension schemes; and insurers. Both are looking to offload their own historic annuity books. Hence our two record-breakers are:

- the largest ever pension scheme buy-in of £4.4 billion entered into by the Airways Pension Scheme with Legal & General; and
- the largest ever “backbook” deal, with Rothesay Life taking on a £12 billion slice of Prudential’s historic annuity book.

As we start a new year, British Airways may (for the moment) retain the record in the corporate pension world, but its mega-trade looks less of a big deal next to the Prudential annuity sale of almost three times the size. Whilst this could be dismissed as an interesting but ultimately meaningless statistic, Gemma Millington argues it merits further attention.

Firstly, with a finite supply of bulk annuity providers in the market, backbooks are big (in every sense of the word) competition for pension schemes. As market demand from pension schemes grows, it will become increasingly important that the providers don’t get distracted by, and divert capacity to, backbook deals. Even if competing solely with other pension schemes for providers’ attention, it is worth considering why interest in pension schemes wanes when a backbook deal comes along.

**How can pension schemes best compete with other market participants and move themselves to the front of the queue? If they can identify what it is that makes a backbook deal more attractive, can they replicate this to competitive advantage in an increasingly busy market?**

Secondly, whilst the main factors limiting the size of pension scheme deals are more likely to be scheme side than insurer side (namely funding shortfalls and availability of liquid assets), is there any other reason why pension schemes lag behind insurers in the size of deals observed to date?

**Is there a feature of backbook deals that means higher deal sizes are (a) preferred (by both the risk taker and the risk shedder) and (b) possible?**

Based on Willis Towers Watson’s experience advising on both sides of backbook deals, including the Prudential-Rothesay Life trade, we address these questions in the following lessons learnt from insurer to insurer transactions. We then consider what this means for pension de-risking deals in 2019.

## Lessons learnt from backbook deals

### 1 Legacy pension liabilities can limit future business growth

Insurers who are no longer active in the bulk annuity market may not wish to tie up resources and capital in managing pension scheme risk. Backbook legacy risk is offloaded to release capital and create opportunities for business growth. Why would a pension scheme sponsor not want to do the same?

### 2 Having insurer-friendly assets in place enables scale and speed and minimises cost

A bulk annuity provider will invest in assets that closely match the pension scheme cashflows it needs to pay and in doing so, benefit from an illiquidity premium. In a backbook transaction the annuity portfolio is already backed by assets that are likely to be attractive to the purchasing insurer, saving them (at least in the short term) investment costs and time, and enabling larger deal sizes than may otherwise be the case if the insurer had to source the assets.

For larger pension schemes considering a buy-in, investment in assets that will appeal to an insurer will help them jump to the front of the queue and maximise the size of deal achievable, as well as making it easier to lock into pricing quickly.

### 3 Having longevity reinsurance in place also enables scale and speed, and minimises cost

The other key influence on bulk annuity pricing and availability is longevity reinsurance, with bulk annuity providers passing on significant chunks of longevity risk to the reinsurance market so as to optimise capital. Backbooks with existing longevity reinsurance agreements will be preferable to pension scheme deals as they save the insurer time and cost in sourcing longevity protection.

Schemes with longevity protection in place, via a longevity swap, are therefore expected to be well placed when it comes to purchasing a bulk annuity. In fact, the Airways transaction incorporated two prior longevity swaps of £1.7 billion. This demonstrates that longevity swaps have now become a stepping stone on the way to eventual buy-in / buyout.

### 4 Splitting liabilities (and assets) into tranches can help maximise bidders and competitive tension

Prudential separately invited bids on four different risk tranches. Although the ultimate deal saw all tranches being reinsured by Rothesay Life, this encouraged more bidders into the process than would have been the case had the deal been presented as an "all-or-nothing" offer. In turn this helped ensure pricing was optimised.

Larger pension schemes should weigh up the potential advantages of approaching the market for pricing on different subsets of membership, balancing maximisation of deal size and insurer engagement against any loss in efficiency from transacting with more than one counterparty. And, of course, ensuring that any liabilities left behind remain attractive.

### 5 Providers prioritise deals based on likelihood of transaction and expected ease and efficiency of the transaction process

Insurers in the bulk annuity market have to make tough decisions as to where to focus capacity and resource. Not only will they have more confidence in a backbook deal proceeding but, in dealing with an experienced counterparty, they will also anticipate an efficient, streamlined process being run.

The more information a pension scheme is able to provide the insurer to give certainty as to the viability of a transaction the higher the level of engagement expected. This includes: transparency on target price; evidence of trustee and sponsor support; and a clear timeline for transaction.

## What does this tell us about pension de-risking deals in 2019?

"As more and more pension schemes close in on their journey plan targets, the increased demand for capacity is likely to drive insurers to become increasingly selective in deploying their capacity. We anticipate that for many insurers this will result in their focus being on the larger buy-in and buyout transactions.

Those pension schemes that are able to offer the market scale and deploy similar techniques to the backbook market will represent the most attractive opportunities for insurers, leading to maximum capacity and optimal pricing."

Ian Aley



## The small scheme dilemma



**Matt Wiberg**

One notable element of 2018 was the return of “mega” deals, with four £1 billion+ deals being written. 2019 is expected to be equally as busy, and insurers will face difficult decisions on where to allocate resources. Should they quote on ten £200 million deals or one £2 billion deal, bearing in mind that the latter is likely to be a small fraction of work of the former? As we enter 2019 one area of focus for our team is helping to ensure that smaller schemes continue to get traction and attractive pricing, despite insurers naturally gravitating to the larger deals. In this article Matt Wiberg considers what smaller schemes should be doing to achieve the best outcome.

### Painting yourself in the best light

In 2018, we saw insurers routinely declining to quote on transactions, particularly at the smaller end of the market, as they did not have the resources or capacity to write all of the deals in the market. When insurers decide which cases to work on, one of the key factors is how likely they believe the deal is to trade. There are a number of simple steps that can be taken to increase the attractiveness of your scheme to the market:

- Demonstrating a joint commitment to the transaction from both the trustee and sponsor gives the insurer confidence that both parties are aligned, increasing the likelihood of the transaction proceeding;
- Being able to articulate a clear pricing target to the market gives insurers confidence that a deal can be agreed and enables them to focus on the pricing they need to achieve;

- Demonstrating a commitment to the transaction by involving third parties such as scheme lawyers, the Scheme Actuary and administrators early in the process by, for example, getting a thorough legal review of the benefit specification before approaching the market; and
- Providing clean and complete data, including gathering up-to-date marital information (status and spouse’s date of birth).

### Building relationships with the providers

Over recent years we have seen a significant increase in the number of pension schemes returning to the market to further de-risk their liabilities, typically by insuring new pensioners. Engaging the market and completing an initial transaction enables the scheme to demonstrate its commitment to the market and as a result these schemes are finding it easier to gain traction from the market when they return to do a follow-on transaction.

These schemes will need to decide whether to transact with the insurer with whom they have an existing relationship, or to run a full market process again. Typically in our experience, the latter leads to a better price outcome, but each case needs to be considered in its own right.

For example, if the follow-on transaction is undertaken with the existing insurer it can typically be completed efficiently by using existing contracts. If there is a desire to lock into pricing quickly, there is therefore an argument for working exclusively with the existing insurer, and using a stretching price target to ensure optimal value is achieved.

Over the last two years, 25% of the buy-in transactions we advised on were follow-on transactions.

### Simplifying the process

As noted above, smaller schemes are proportionally more work for the insurer than larger deals, and this is reflected in the premium as well as in the lack of appetite to quote—a double whammy! It's also increasingly the case that for small deals insurers aren't willing to make meaningful changes to their contractual terms, again leaving smaller schemes disadvantaged.

One solution is for several schemes with the same sponsor to approach the market together to increase their buying power, as we have done in several cases in the last couple of years. Another is Willis Towers Watson's Streamlined Bulk Annuity Service, which was designed to counter and mitigate the above challenges, enabling a number of schemes to access improved pricing as well as enhanced commercial terms via a standardised off-the-shelf process incorporating pre-negotiated legal contracts. More insurers quote as they understand the process and pricing is more attractive with this approach as the insurer's expenses are kept low. In 2018, six of our clients transacted using the Streamlined Bulk Annuity Service.

Turning to longevity swaps, whilst traditionally these have been mainly considered by larger schemes, longevity swaps for as little as £100 million of pensioner liability have recently become really attractive. One of the key drivers behind this is that we continue to see greater streamlining and standardisation of the contractual and operational arrangements, as demonstrated in the case study below.

## Case study: £300 million longevity swap with Legal & General

Our client wanted to secure longevity insurance for the scheme's pensioners. Once the trustee and sponsor had identified a longevity swap as their preferred solution, Willis Towers Watson approached the market and identified Legal & General's streamlined structure as the best option for meeting the client's needs.

Under the streamlined structure, the contract was much easier to put in place and run than has been the case historically. This, in turn, leads to a reduction in costs and ensures competitive pricing for schemes of this size.

In August 2018, our client entered the longevity swap with Legal & General, its first streamlined longevity insurance contract, covering 700 pensioner members and around £300 million of liabilities. The contractual negotiations were completed in a matter of weeks from entering exclusivity.

Legal & General's streamlined structure brings helpful competition to the smaller size longevity swap market, and allows trustees to hedge longevity risk at very attractive costs.

# Interview with Phoenix Life



Shelly Beard



Justin Grainger

Phoenix Life entered the bulk annuity market in 2018, with three pensioner buy-ins including two led by the Willis Towers Watson team. In this interview, Shelly Beard talks to Justin Grainger of Phoenix Life about a successful first year in the buy-in market and what we can expect to see from Phoenix in future.

## 1. Congratulations on successfully entering the buy-in market in 2018. You completed three deals – what were your highlights?

Clearly, our first external transaction with the Marks & Spencer Pension Scheme was an important milestone for us, proving that Phoenix Life can compete in this rapidly growing market. The two further deals we have completed in Q4 have built upon this, giving us a really strong foundation for next year. We're really pleased with writing £800 million of business this year, which is in line with what we set out to do at the start of 2018 when we were framing our ambitions for this market.

## 2. What's been your biggest learning point during the year?

It's been a really busy market this year and we are a relatively small team (22 individuals across the different parts of Phoenix's bulk annuity business), so we have needed to focus on the right deals. At the beginning of the year, we were seeking to quote on as many deals as we could to understand the pricing dynamic. However, as we have developed our strategy and learnt more about which deals work best for us, we have become more selective.

For us, it is also really important that we maintain pricing discipline. This means being patient and sometimes deciding not to participate – a deal has to make financial sense for our business; we are not in this market to chase volume.

## 3. What was the rationale behind Phoenix's decision to enter the buy-in market?

Phoenix Life has a substantial portfolio of annuity business from previous mergers and acquisitions (M&A) activity. Bulk annuity business from pension schemes complements this existing business and our asset sourcing capabilities mean that we are well placed to compete in this market.

Phoenix Group sponsors three defined benefit pension schemes of its own, so we feel we understand both the needs of pension scheme trustees as well as the corporates that sponsor them.

## 4. What do you think is Phoenix's differentiator in the market?

Whilst the pensioner buy-in market is principally price driven, we hope we have demonstrated in the deals we have completed that we listen carefully to the requirements of trustees and are pragmatic in seeking solutions that work for their situation.

So far, we've tended to focus on mid-size deals – of between £100 million and £500 million – which suits our appetite, although we would consider slightly smaller and larger deals, in the right context.

## 5. Do you have any plans to further develop your proposition, for example to include non-pensioners?

We are working on our proposition for covering deferred pensioners, particularly in light of the demand we are seeing from pension schemes as more look to buyout.



**6. Do you think the very attractive pricing currently being offered in the market is sustainable long term?**

Attractive pricing is a function of the assets available and the competition between insurers for business. Ultimately, while some of the very best pricing of 2018 (particularly that seen in early summer) might not be sustainable in the long term, we think there is a level in this market where pricing is attractive to pension schemes whilst also offering an attractive return on capital for insurers.

**7. Any predictions for how big the bulk annuity market could be in 2019 and beyond?**

A feature of 2018 has been a few very large transactions making up a sizeable chunk of overall volumes. We also expect 2019 to be busy, though whether it hits the heights of 2018 may again depend on a few large deals. Looking further forwards, given improved levels of scheme funding across the board, there is no reason to expect that the market will not show steady year-on-year growth thereafter.

**8. Finally, what are Phoenix’s ambitions for 2019?**

We are looking at completing deals worth £500 million - £1 billion next year. However, we are not volume-focused, which means we will be selective in our choice of deals – our decision-making process is ultimately focused on whether bulk annuities or other M&A activity is the best use of our capital.

Our ability to compete in the bulk annuity market is heavily influenced by our asset sourcing capabilities and in that regard we feel we are well-positioned to benefit from the recent growth in this market in 2019 and beyond.

**The lowdown on Phoenix Life**

- The largest life and pension consolidator in Europe
- £240 billion assets under administration
- c£4 billion market capitalisation
- 10.1 million policies
- Locations across the UK and in Germany, Austria and Ireland

# Spotlight on: Recent innovation in alternatives to buyout



Suzanne Vaughan

Few trustees these days are counting on their sponsors to support their defined benefit (DB) schemes indefinitely, and from their perspective, even fewer sponsors wish to retain the financially onerous legacy of past employees. In fact, following the high profile cases of BHS, Carillion and British Steel, The Pensions Regulator's tolerance for schemes burying their heads in the sand is at an all-time low. Pension schemes are being warned to plan for financial independence — what is the end-game? How will you get there?

Getting a scheme to a position where it has increasingly delegated responsibility for paying benefits, and can reliably pay its members without the backing of a sponsor has to be, therefore, a main strategic objective. But the options for schemes to consider go far beyond bulk annuities. Here, Suzanne Vaughan considers three of the newer options added into the mix — commercial consolidators, non-traditional insurance products and fiduciary asset management.

## Commercial consolidators

This can be conceptualised as a DB master trust, where the employer covenant is replaced by a capital buffer. It differs from the current regime by allowing the sponsoring employer to separate from its pension scheme by putting a price on the value of its covenant. This is similar to a buyout of liabilities, although the new vehicle would be outside the insurance regime and so not subject to the capital requirements of the Solvency II Directive. It should, therefore, be more affordable than an insurance buyout, albeit that this will be at the cost of a lower degree of benefit security.

The Government White Paper in 2018 acted as a catalyst, with the first commercial consolidators, Clara and The Pension SuperFund, quickly launching to market with respective offerings. One of the most notable differences between these two is that Clara promotes itself as a “conduit” vehicle with the stated aim of transitioning liabilities to the insurance market over the medium term, say around 10 years. The Pension SuperFund on the other hand is more a “destination” vehicle, looking to hold assets and liabilities over the longer term, benefiting from economies of scale to drive down costs and drive up investment returns.

Before transferring to a commercial consolidator, there is a duty on trustees of the original scheme to satisfy

### Under the commercial consolidation model

- A private company sets up a new DB pension scheme
- It takes over the responsibility for meeting the liabilities of a pension scheme in exchange for a one-off payment or structured payments by the previous sponsoring employer
- The private company then acts as the ‘sponsor’ with a new board of trustees responsible for scheme governance
- The covenant is provided by additional capital supplied by external investors who expect a return for their investment

themselves that the funding level of, and security in, the consolidator effectively covers the ongoing support otherwise expected from the original sponsor. Trustees weighing up a transfer are unlikely to find this straightforward, particularly as no formal guidance is expected from The Pensions Regulator, and because the costs and the long-stop protections of the alternative regimes are markedly different. Trustees will need to compare the likelihood of receiving potential future contributions from the sponsor versus the “bird in the hand” of a contribution and additional physical capital today.

If the cost of settlement through a commercial consolidator is only slightly different from a buyout with an insurer, it is difficult to see many trustees (or corporates) viewing them as attractive. If it is materially cheaper, they will need to consider to what extent the likelihood of members receiving full benefits reduces – the fundamental trade-off is between cost and security. Detailed legal, actuarial and covenant advice will be needed.

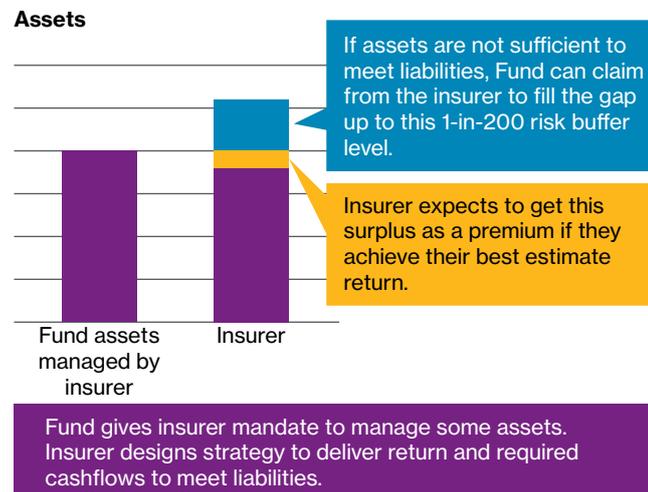
2019 is sure to be a fascinating year in this regard as the outcome of the Department of Work and Pensions' recent consultation into the regulatory framework for these new operating models becomes known and is debated by Parliament. Our expectation is that regulatory clearance will play a key role in the first wave of such deals as collectively trustees, sponsors and the Regulator get fully comfortable with the concept.

### Non-traditional insurer products

New entrants are not the only ones that we have seen develop their offerings in scheme end-game territory. Those insurers currently providing bulk annuities continue to innovate and create new solutions to improve affordability for schemes and sponsors. One that most notably comes to mind is the “Insured Self-Sufficiency” offering from Legal & General, something part way on the journey between traditional scheme self-sufficiency and buy-in with an insurer.



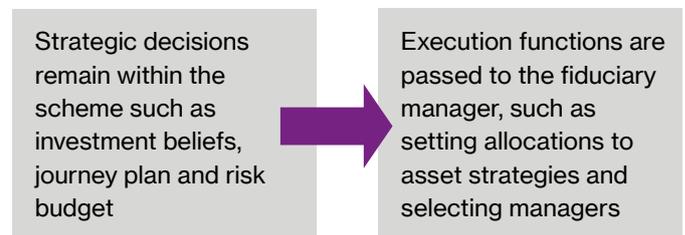
At a high level, this proposal is a means of implementing a cashflow matching approach, whereby a premium is paid to provide the scheme with downside investment protection in all but tail (1-in 200) events as assessed at outset. Further, a mechanism is incorporated such that upside investment performance and demographic improvements provide returns to the scheme and ‘profit’ to Legal & General.



The trade-off for consideration here is whether the increased (but not 100%) certainty for the scheme about the future funding path and contribution requirements, together with improved covenant due to the additional capital backing from the insurer, outweighs the fact there remains a reliance on the sponsoring covenant while the arrangement is in place and there is an explicit cost of de-risking in terms of the premium payable to the insurer.

### Fiduciary asset management

What is fiduciary asset management? It is the delegation of investment implementation to a professional, giving a scheme access to more efficient investment strategies, real-time decision making and relieving the governance constraints of pension fund committees.



Delegating implementation allows trustees more time to focus on key strategic issues and long-term goals of the scheme, while remaining fully accountable for the investment strategy and design of the strategic mandate for the fiduciary provider to execute. The best fiduciary providers use their scale and influence in the market to negotiate the lowest fees and most advantageous terms. The decision to invest in partial buy-ins can also be delegated under the WTW offering.

### Choosing the right option

There is no “one size fits all” answer when it comes to selecting the ‘right’ end-game destination for a scheme. Inevitably this needs to consider the scheme’s current funding position, the make-up of its membership, insurer pricing and, most crucially, how the sponsor covenant is expected to develop over time.

So what approach might be right for your scheme? While we expect buyout, or more likely a series of buy-ins will still be the most favoured end-game, increasingly we believe schemes will find their way to this destination via a fiduciary investment mandate or perhaps one of the non-traditional insurance products. While the new commercial consolidator option is unlikely to be suitable for all, given potential concerns around reduced security relative to the sponsor covenant, it is clear this model has its place in the settlement market, with many willing it to succeed as a viable alternative destination for pension scheme provisions as more and more schemes reach this point in their life cycle.

# Where next for the bulk annuity market?



Will Griffiths

Will Griffiths reviews his predictions from last year and takes a look forward at what 2019 might have in store for the bulk annuity market

Much like a repeat bulk annuity transaction, writing my second annual prediction article is made somewhat easier by the investment of time made in the first....

## Look back at 2018 predictions

The main theme of last year's article was that 2018 was going to be an incredibly busy year, with an unusually busy Q1 helping to make 2018 a record breaking year in terms of the amount of business written. As previously noted in this report, this proved to be true with more than £20 billion of premiums having been announced, helped in no small part by the £2.4 billion deal for the Nortel Network Pension Plan and the £4.4 billion pensioner buy-in for the Airways Pension Scheme.

I also touched on the possibility that financial volatility, while in many cases creating unwelcome uncertainty, may also lead to pricing opportunities, in particular if credit spreads widened and risk-free yields increased. Both of these did come to pass with corporate spreads (depending on exactly which corporate bonds are being considered) moving out some 40bps over the year. Focusing on total change though masks the volatility seen over the course of the year, as illustrated in *Figures 5 and 6*.

I also talked about the resolution of the 'longevity dilemma', in that the heavier than predicted deaths experience had started to flow through to bulk annuity pricing. However, this trend seems to be continuing, so while this should continue to flow through in to pricing, there is inevitably a small time lag between the official data and studies being made available and the insurers getting comfortable with allowing for this in their pricing.

Figure 5. Credit spreads over 2018



Source: Factset

Figure 6. 10-year gilt yields



Source: FTSE Actuaries Government Securities Indices



## 2019 Crystal Ball Gazing

Part of this is easy – Q1 2019 will be busy, very busy! We can see this already from the cases we have lined up with the market and from our conversations with the insurers and reinsurers, who report pipelines totalling between £30 billion and £40 billion, larger than any prior year. However, the full year outcome is much trickier to predict with a number of factors at play, all pulling schemes, sponsors and insurers in different directions.

Brexit and Guaranteed Minimum Pension (GMP) equalisation in particular may weigh heavily on sponsors' and trustees' available time, which may well mean that if a bulk annuity transaction isn't at the top of both of their respective 'to do' lists then it is less likely to happen than in previous years.

That said, the affordability of buy-ins and buyouts has never been better for schemes and this is likely to continue to drive demand and mean that 2019 achieves greater volumes of business than 2018. We expect more "mega" deals – 2018 saw four deals of more than £1 billion in size and there is potential for double that in 2019.

### **Brexit**

This will be a key issue in determining activity in 2019, particularly from the perspective of many sponsors. For those significantly impacted by Brexit it is likely to be a challenge for them to spend as much time on their pension schemes as they otherwise might, at least until there is greater clarity for their wider business and any changes they need to make have been implemented.

However, even if all parties agreed to focus on a transaction at the start of 2019 it is unlikely (but not impossible) for it to have completed before the UK's planned withdrawal from the European Union on 29 March. Should schemes therefore wait to kick off the process later in the year? Two possible reasons why both parties might wish to press ahead now spring to mind:

- Pricing opportunities could well arise alongside financial volatility for those able to move quickly.
- The uncertainty created may mean that insurers are keen to write as much business as possible, as soon as possible in 2019, which in turn may lead to some downward pressure on their pricing during Q1.

One other potential trend could be that if, as a result of Brexit, companies headquartered overseas pull out of their UK operations, there may be an uptick in buyouts for the pension schemes left behind. Such a trend may take more than just one year to emerge but could be given added momentum if we also see a serious weakening in sterling, making a transaction appear cheaper from the overseas sponsor's perspective (although in turn the value of their UK business is also likely to be similarly diminished).

All the above is predicated on Brexit moving ahead broadly as currently envisaged, mainly as an exit under some sort of withdrawal agreement, featuring a transitional period. However, should we fall into 'no-deal' territory or end up with another vote of some kind (be it a General Election or second referendum) then all bets are off as to what the impact might be.

## GMP equalisation

It is expected that the recent Lloyds' judgment will herald a period in which many pension schemes will focus a significant chunk of time in 2019 on equalising their members' GMPs. Trustees are understandably keen to pay the correct benefits as soon as possible and are no doubt already being contacted by members on this, prompted by the newspaper headlines on the 'windfalls' they are soon to receive. It will also be an issue high on the agenda for many sponsors, not least as their auditors are likely to expect an allowance to be made in their next set of accounts. Of course, the sponsors in question will also be expected to fund the additional benefits...

So how does this impact on the bulk annuity market?

1. I'd expect for many schemes there will be an effort to get on with the equalisation quickly, to the extent that any other non-critical projects, which for some schemes may include a bulk annuity transaction, are delayed. This may not be the case for all pension schemes but it could have a noticeable impact on volumes of business
2. Initial indications from insurers are that they would want to avoid implementing a year-by-year test (the C2 method in the Lloyds' judgment), mainly as a result of the significant extra administrative burden this would create. I can understand this approach, especially as with GMP conversion there is a ready-made solution to removing this test. Further, such conversions could lead to potential cost savings on the premium if the GMP is converted away from CPI linked increases (CPI being harder, and therefore more expensive, for insurers to accurately hedge)

Ultimately, schemes would have had to do this work at some point before buyout and individual policies being issued to members, and now it seems to be the case that a lot of this work will be brought forward, possibly leading some schemes to push back timescales for a transaction. However, it's likely that the amount of work required and the financial impact of equalisation will not be dissimilar to the approach that the vast majority of schemes implemented when buying out prior to the Lloyds' judgment.

A final word on GMP – we're frequently being asked whether buy-ins need to be delayed until after GMPs have been equalised. The answer here is a firm no – the adjustments to benefits to reflect GMP equalisation can be made later via an additional premium payment, either during the 12-month data cleanse following the buy-in trade, or under a contractual obligation that insurers must allow schemes to equalise pre-buyout.

## Commercial consolidation

As Suzanne has already covered, there are now two commercial consolidators and their first deals are expected in 2019. Once the first few pension schemes have gone

down this route, there is likely to be a number of others that will then start to give this option serious consideration. It's unclear at this stage how many schemes may ultimately go down this route, but in the short term it could well put an extra decision point in projects for sponsors and trustees, leading to a delay in approaching the bulk annuity market. For a small number of schemes, it may also lead to an impasse between the sponsor, which favours the less expensive commercial consolidation route, and trustees, who prefer to place their members into the more expensive insurance regime.

## Asset availability

Key to attractive pricing is an insurer's ability to allocate high yielding illiquid assets towards a given transaction. This becomes harder as insurers write more business for two main reasons:

- The insurer will need to source more of these assets, which can be a time consuming process due to the analysis and due diligence often required on the bespoke assets being offered for sale.
- There will be greater demand across the market for these assets, meaning any given insurer is less likely to win a competitive process for the asset and the bidding itself is likely to result in a lower yield being achieved on the asset.

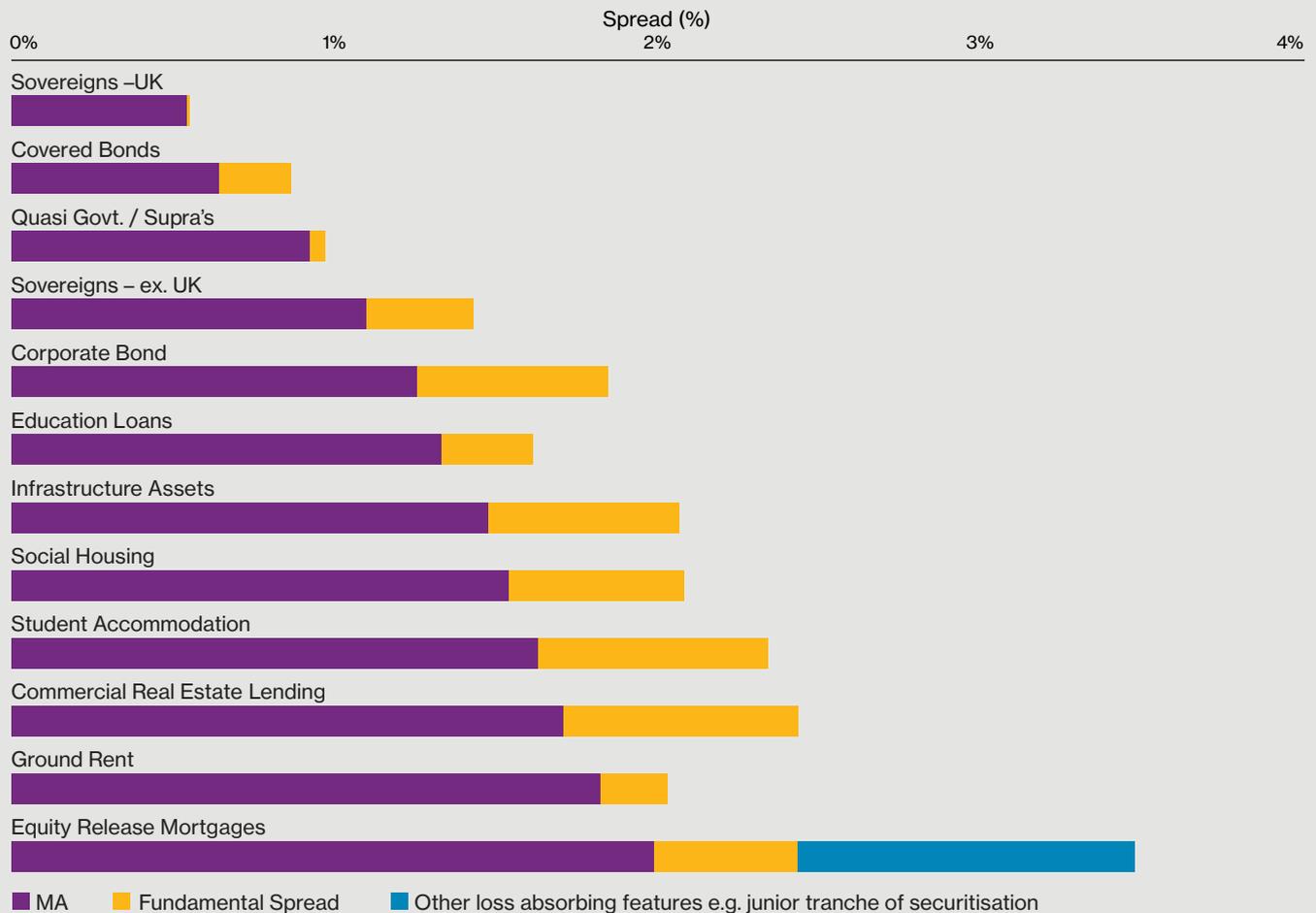
During 2018, due to the amount of business being quoted on, we saw some insurers start to struggle with high yield asset availability. In some cases, this resulted in either their pricing increasing or alternatively they had an inability to provide a guaranteed, transactable quote as part of the bidding process.

One issue that was expected to be a challenge in 2019 was the use of Equity Release Mortgages (ERMs) by insurers. In particular, the Prudential Regulation Authority (PRA) was considering how insurers should allow for the risk that the no negative equity guarantees provided to home owners on these products bites in future years.

One expected outcome was that insurers would need to reserve more prudently for this risk, which in turn would likely lead to a reduction in the yield achieved on these products (though some of this hit would be passed on to the customers taking out these products). As can be seen from *Figure 7*, the yield from this asset class is at the top end of what insurers can expect to generate, so anything that reduces this is then likely to lead to an increase in bulk annuity prices to some extent. However, the good news is that the PRA has recently issued a response to its consultation and the outcome is not as severe as expected.

The impact on pricing of new bulk annuity business will likely vary significantly from insurer to insurer depending on how heavily a given insurer used ERMs on new business, although we expect most insurers to be impacted.

Figure 7. **Bulk annuity pricing**



Source: Bank of England Calculations based on data submitted by insurers, 31.12.2016. Average Spread by Matching Adjustment Asset Class. Market Value and Duration Weighted results. <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2018/solvency-ii-equity-release-mortgages.pdf?la=en&hash=31902C11282C69E81357B83E9FE5294D0E9E18D8>

### Longevity swap pricing and availability

Following Solvency II, insurers are now typically putting in place longevity swaps in respect of new bulk annuities they transact, meaning that reinsurers' longevity swap pricing is flowing through directly to determining the life expectancy assumptions underlying all transactions in this market.

In 2018 we've seen an incredibly competitive longevity swap market, with this competition forcing reinsurers to be early adopters of heavier mortality assumptions and CMI2017.

With the potential for further heavy deaths experience in the early months of 2019, we'll again be working hard to get this reflected in pricing as soon as possible. Potentially of more concern is the supply / demand dynamic in this market as well, which may lead to an upwards drift in pricing.

The reinsurers are also seeking a balanced book of business in terms of the lives they reinsure – particularly a mix of blue collar / white collar and a good geographical spread. Pipelines for this market in 2019 are currently dominated by white collar workers, and we expect there will be opportunities for blue collar schemes to pick up particularly attractive longevity swap pricing throughout the year.

### Overall

I'm expecting 2019 to start with a bang and continue from there. Whilst there are a number of headwinds for this market – not least Brexit and GMP equalisation – pricing is likely to remain attractive and affordability will drive more schemes than ever to approach the market. I look forward to another busy year!

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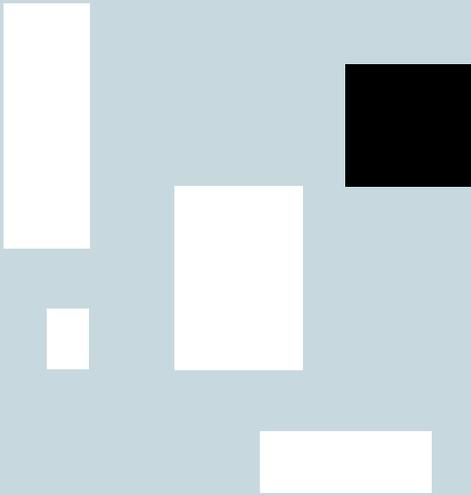


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