Soaring to great heights

De-risking report 2020

January 2020

Willis Towers Watson

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Contents

Our credentials

Size and volume

- Experienced adviser on transactions ranging in size from £1 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 with experience of over 800 transactions, including leading transactions in 2019 covering more than £12 billion of liabilities
- Advised more than 20 schemes that have put in place multiple buy-ins, using both umbrella contracts and open-market approaches
- Leading adviser to insurers on annuity portfolio sale transactions
- Advised on over half of all public domain longevity swaps including the two largest longevity risk transfers ever: the BT Pension Scheme and the HSBC (UK) Bank Pension Scheme longevity swaps

Innovation

- We have an unrivalled history of leading innovations and embracing new ideas. For example we were the lead adviser on:
  - ✓ The first collateralised buy-in
  - ✓ The first all-risks buyout
  - ✓ The first captive buy-in
  - ✓ The first software tracking system used by an insurer to track live 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
  - ✓ The first longevity swap using a captive, which was a Guernsey-based cell. We subsequently led the first longevity swap using a Bermudan captive
- 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 that 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 the available longevity hedging 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 2020 de-risking report in which our experts look back at the record-breaking activity of 2019 and predict key themes in the longevity hedging and bulk annuity market over the next year.

2019 was a landmark year on many counts. In what was the 10th anniversary of the first longevity swap and the 20th anniversary of the first buy-in, we have seen the de-risking markets hitting the headlines. The driver was not only unprecedented levels of bulk annuity transactions, with around £41 billion of liabilities insured, but also the size of the liabilities hedged. We saw the largest buy-in to date when telent and the Trustees of the GEC 1972 Plan entered into a £4.7 billion buy-in with Rothesay Life. We also saw the second largest longevity swap ever completed when the HSBC Bank (UK) Pension Scheme entered into a £7 billion longevity swap with Prudential Insurance Company of America (see page 13 for a case study). On the next few pages, Katherine Gilder considers the key themes from 2019 and Suzanne Vaughan provides her tips for schemes looking to approach the market in 2020.

Outside pensions, the UK political environment dominated the headlines in 2019. The unexpected dissolving of parliament at the start of November led to delays in the agreement of a regulatory regime for the commercial consolidator market and also for the Pension Schemes Bill, which required trustees to have a documented strategy for ensuring long-term provision of scheme benefits. Costas Yiasoumi considers what the Bill means for the insurance market and Tom Ashworth considers what a new regulatory regime might mean for the commercial consolidation market.

What else can we expect from 2020? On page 11 two of Willis Towers Watson's mortality thought leaders, Cobus Daneel and Jamie Jones, consider recent trends in mortality and what this means for the longevity de-risking market. Sadie Scaife also shares her views on what we might expect from the bulk annuity and longevity swap markets in 2020.

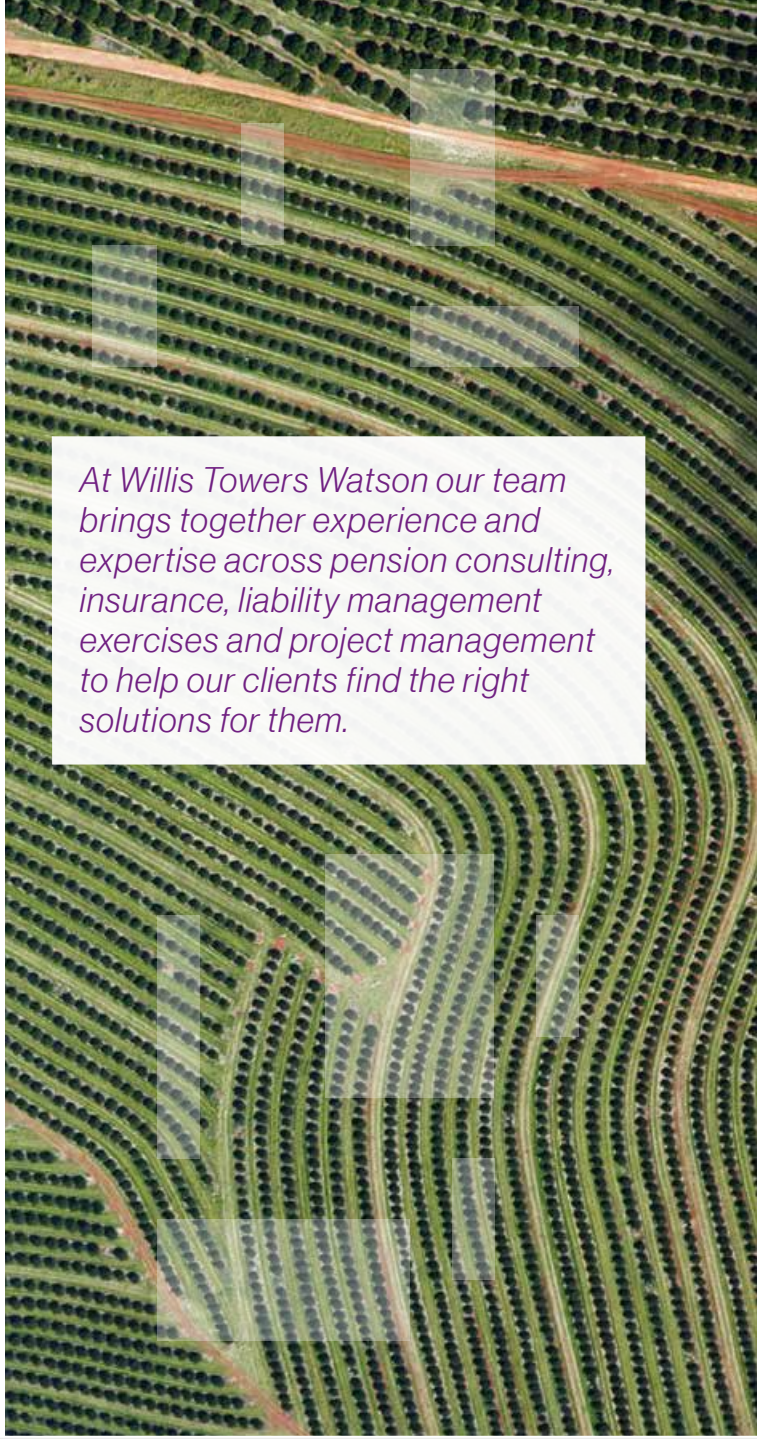
A question we are often asked is about the strength of insurers as counterparties to a transaction. On page 19 in Will Griffiths' interview with Adolfo Aponte of Lincoln Pensions, Adolfo shares his views on how covenant advice can add value to the bulk annuity process.

Finally no pensions publication would be complete without a GMP article. A recent Wills Towers Watson survey revealed GMP issues as the joint-top current issue for pension scheme decision makers, and Lucy Wilson shares the latest insurance market views on GMP equalisation.

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 opportunities in this market for your scheme.

Ian Aley
Head of Transactions



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Looking back at 2019

Katherine Gilder

2019 was another record-breaking year in the bulk annuity and longevity hedging market, with volumes considerably in excess of those predicted at the start of the year. Katherine Gilder considers the trends in 2019 and what this could mean for 2020.

The bulk annuity market

For the past couple of years the bulk annuity market has seen a dramatic increase in the volumes of liabilities transferred to the insurance sector and 2019 continued this trend, with around £41 billion of bulk annuity business written, representing more than a threefold increase from the market only two years ago (see *Figure 1*). Along with the significant volumes, multiple records were broken:

- We saw the record for the largest bulk annuity transaction to date broken – the Airways Pension Scheme previously held the title following their £4.4 billion deal with Legal & General in 2018. This record was broken twice in 2019, first when the Rolls Royce UK Pension Fund entered into a £4.6 billion deal with Legal & General and then with the GEC 1972 Plan's £4.7 billion transaction with Rothesay Life.
- We also saw the largest bulk annuity to date including both pensioners and deferreds when the British American Tobacco Pension Fund agreed a transaction with Pension Insurance Corporation in May. Again this record was soon broken by the Allied Domecq Pension Fund's £3.8 billion buy-in covering their pensioners and deferreds with Rothesay Life in the third quarter of 2019 and the GEC 1972 Plan's £4.7 billion transaction with Rothesay Life.

In 2019...

around £41 billion

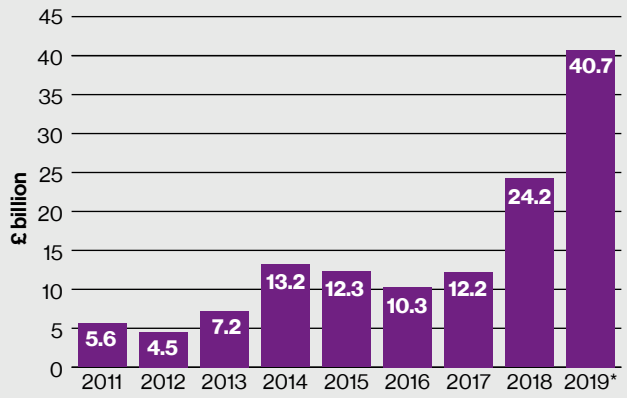
of bulk annuity business was written, representing **more than a threefold increase** from the market only two years ago

The record for the largest bulk annuity transaction to date was broken twice:

1 **£4.6 billion** Rolls Royce UK Pension Fund with Legal & General

2 **£4.7 billion** GEC 1972 Plan with Rothesay Life

Figure 1. **Volumes of bulk annuity business by year**



*Transactions led by Willis Towers Watson or publicly announced to date
Source: Willis Towers Watson, December 2019

As can be seen from the records broken, the notable trend for 2019 was the increase in the size of transactions. In total we saw five bulk annuity transactions, each over £3 billion in size, compared with 2017 when there were no transactions over £1 billion. While we saw a significant increase in the volumes of liabilities transferred to the insurance market, this was really a result of a number of very large transactions during the year; in fact the number of deals completed fell significantly in 2019 relative to previous years. In some instances, such as with Airways Pension Scheme and Rolls Royce, the large deal size was facilitated by the fact that they had previously completed a longevity swap that was transferred to the bulk annuity insurer.

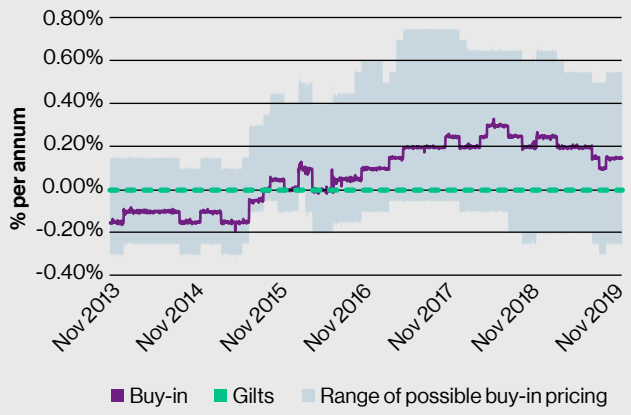
Over the course of the year insurers became increasingly selective as to which cases they were able to or willing to quote for, with resource constraints meaning some needed to focus their efforts on larger transactions. On occasion this meant some smaller schemes found it harder to obtain sufficient market interest, although well-run and efficient projects with proactive engagement and clear objectives were able to access good pricing. Suzanne Vaughan shares some of her tips for a well-run process on page 14.

Following a number of years where most transactions were pensioner buy-ins, the other notable trend in 2019 was the re-emergence of buyouts. Strong asset performance and lower than expected increases in life expectancy drove an improvement in funding levels. This, combined with attractive bulk annuity pricing, led some schemes to realise buyout was affordable much earlier than previously expected.

With such high demand in the bulk annuity market, how did pricing evolve over 2019?

The consistently attractive pricing levels witnessed in 2017 and 2018 continued through the early part of 2019, as shown in *Figure 2*. This helped the market reach record levels of £18 billion of bulk annuities in the first half of 2019, compared to around £8 billion in the first half of 2018. This was a very different pattern for a market that often sees a slow start to the year.

Figure 2. **Pensioner buy-in pricing over recent years**



Source: Willis Towers Watson, December 2019

In fact the latter months of 2019 saw pricing deteriorate slightly, although it was still favourable compared to funding with gilts. A fall in credit spreads and insurer concerns about volatile markets during the extended Brexit period drove the deterioration towards the end of the year, exacerbated by insurers seeking to manage activity into 2020, as most had already achieved their desired new business volumes for 2019.

One takeaway from *Figure 2* is the importance of choosing the right time to complete a transaction rather than simply leaving it to chance. Knowing your target price, retaining price discipline and flexibility are all key to achieving the best possible deal in the current market.

Following a number of years where most transactions were pensioner buy-ins, the other notable trend in 2019 was the re-emergence of buyouts.

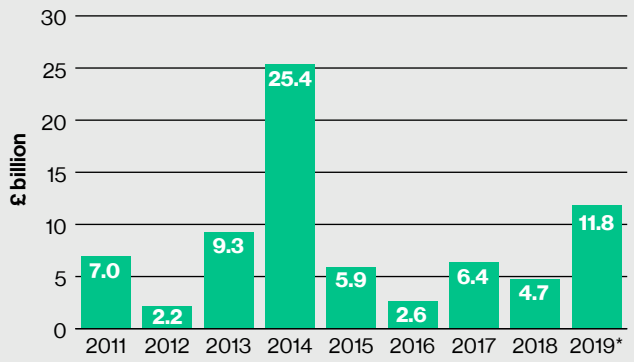
What happened in the longevity swap market during 2019?

As was the case with the bulk annuity market, the longevity swap market was also incredibly busy in 2019. Many of our clients, monitoring market pricing and observing that longevity swap pricing was at its lowest levels since the market was established some ten years ago, looked to hedge this risk (see *Figure 3*). Indeed in 2019 we saw the second-largest longevity swap ever completed when the HSBC Bank (UK) Pension Scheme entered a longevity swap with Prudential Insurance Company of America (PICA). You can read more about this transaction in our case study on page 13.

Given most schemes have seen decreases in life expectancy reducing their liabilities at their most recent valuation, is now the right time to hedge longevity risk? It shouldn't be forgotten that, prior to the most recent reductions, increases in life expectancy added around 10% to pension scheme liabilities in the previous decade. On page 11 we highlight how 2019 saw significantly below-average death numbers and noticeable improvements in mortality rates, again meaning that we will see an increase in life expectancy for the first time in many years when the CMI publish their projections model early this year. Many also believe that longevity risk is an unrewarded risk because, unlike the case with taking investment positions in pursuit of a reward, there is no gain where pensions are paid for longer than assumed. There may also be a short-term market opportunity for schemes with many blue-collar members to pick up particularly attractive longevity swap pricing, as much of the current activity relates to white collar schemes and reinsurers are very keen to diversify.

In summary 2019 continued 2018's theme of breaking records and pushing boundaries. With the Pensions Regulator increasingly focusing on long-term funding targets, what does this mean for the insurance market? How can schemes demonstrate well-run processes in order to engage insurers? How is the consolidation market developing? Read on to hear from our experts.

Figure 3. **Volumes of longevity swap business by year**



*Transactions led by Willis Towers Watson or publicly announced to date
Source: Willis Towers Watson, December 2019

We saw the second-largest longevity swap ever completed:

£7 billion

HSBC Bank (UK) Pension Scheme with PICA

The Pension Schemes Bill and what this means for the insurance market

Costas Yiasoumi

The upcoming requirement to establish a long-term funding and investment strategy will lead to an increased focus on longevity risk management through bulk annuities and longevity swaps. Costas Yiasoumi explains why.

Where we are

It may surprise observers outside the pensions industry that there is no current legal requirement for trustee boards to have a clear, long-term plan of how they will ultimately meet benefit promises to members and beneficiaries. This will change with the proposed Pension Schemes Bill (draft published in January 2020). The Pensions Regulator's 2019 annual funding statement explains why this is important – see below.

> *"Paying the promised benefits is the key objective for all schemes. This requires schemes to look ahead and set clear plans for how the objective will be delivered."*
>
> **The Pensions Regulator, March 2019**

The funding and investment strategy will need to explain how the trustees intend to deliver benefits over the long term. Trustees will be expected to map out the funding and investment journey to reach their long-term objective, including how to manage risks along the way. We have helped many trustee boards and sponsors develop robust, scheme-specific strategies that do just this. Our experience is that a well-defined strategy and understanding of scheme risks provides a strong foundation for clear decision making, identifying insurance opportunities and ultimately improving the benefit security of members.

The process through which a long-term objective is developed is not for this article – what we address below is why the focus on managing longevity risk will increase for two typical such objectives: running off with a low reliance on covenant or full buyout.

Figure 4. **Example long-term objectives**

- Running off with low-reliance on covenant (sometimes called 'low dependency' or 'self-sufficiency')
- Full buyout
- PPF plus buyout
- Transfer to a commercial consolidator (a nascent option)
- Run-off as a 'scheme without a substantive sponsor' (SWOSS)

Example 1: Objective to run off with low reliance on covenant

As the name suggests, this means getting to a position whereby the trustee board expects it can run-off the scheme with little likelihood of needing additional funding in future from the sponsor, beyond what may already have been provided as contingent security. A typical such strategy involves investing in assets that provide reliable income to match pension payments – in other words a cashflow-driven investment strategy.

So why is managing longevity risk a natural consequence when targeting to run off a scheme?

1. **Investment risk starts being measured on a "cashflow" basis:** investment risk is often measured as a Value at Risk (VaR), a representation of potential worsening in the value of the assets compared with the value of the liabilities. However, if a scheme is investing on a cashflow-driven basis the value of the assets and liabilities is of less importance. What matters is not market-value volatility but instead the likelihood that assets held will generate the required income to pay pensions – these are measures of the reliability of cashflows not the market values of investments. Under these measures of risk, the more predictable and stable the asset cashflows are, the lower the investment risk and hence the higher proportion of overall risk represented by longevity. This supports hedging longevity risk either through longevity swaps or bulk annuities, both of which reduce that longevity risk.
2. **Longevity risk starts being measured on a whole of life basis:** many schemes measure longevity risk but often on a one-year Value at Risk (VaR) basis for comparability with investment risk measures. There is nothing wrong with that but, if the objective is truly to have low reliance on covenant, it makes sense to start measuring longevity on a whole-of-life basis. Simply put, what is the plausible amount by which the pensions we need to pay could increase over the next 30-40 years? The quantum can be enormous – often as high as 15-20% of liabilities.
3. **Fewer levers to repair problems:** if the plan is to run off with a low reliance on the sponsor then reducing all but the longevity risks could pose a threat to the sustainability of the run off strategy. Should longevity risk move against the scheme then it could be necessary either to re-risk or seek contributions, both contradicting the intended strategy. A commonly held misconception is that buy-ins can't form part of a low-dependency portfolio – our experience is that, by using a suitable analysis framework, informed decisions can be made on the role a buy-in can play, the optimal buy-in size and target price.

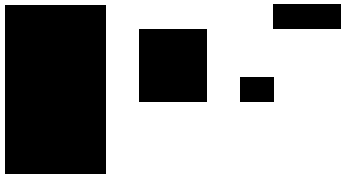
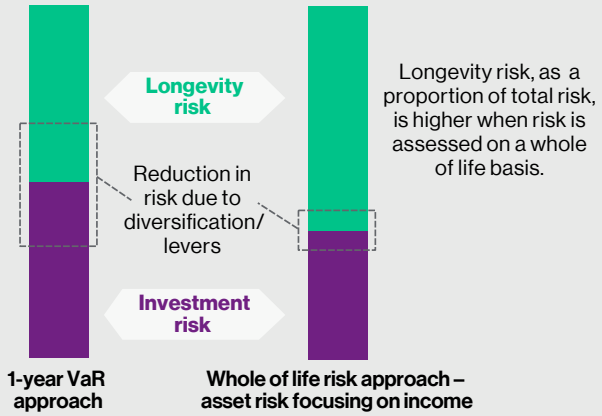


Figure 5. **How longevity risk manifests itself**



Note: The proportions of each risk element are illustrative. They do not reflect the probable actual proportions that would be derived on a scheme-specific analysis

If the objective is truly to have low reliance on covenant, it makes sense to start measuring longevity on a whole-of-life basis.

As more and more schemes firm up their long-term objective, their journey plan to achieve this and make progress against those plans, the insurance market is expected to see increased demand for buy-ins and longevity swaps.

Example 2: Full buyout objective

There are significant factors leading to longevity risk being a focus for schemes with the objective to become fully bought out:

1. **Longevity risk becomes a pricing issue:** if the aim is buyout then what matters is how the insurance and reinsurance market will price your own scheme's longevity in the short window of time when you're seeking a buyout transaction. This will be influenced at the time by insurers' views of your scheme as well as supply-demand dynamics in the market at that point. This can introduce significant uncertainty even over shorter timeframes to buyout. Managing longevity risk in the shorter term can therefore significantly reduce the volatility of future pricing and hence increase the prospects of achieving the objective.
2. **A matter of when, not if:** insurers make significant use of longevity reinsurance. In fact most buyouts will involve an insurer reinsuring at least some of the longevity, if not immediately, then at a later date. The cost of the longevity reinsurance is therefore explicitly or implicitly incorporated within the premium quoted for a buyout. Hence, when it comes to incurring the cost of dealing with longevity risk for schemes targeting buyout, the question becomes one of when rather than if that cost should be incurred, with the risk not being managed until the cost is faced.
3. **The fall-back: a scheme may not reach buyout.** Perhaps investments underperform, the buyout market becomes expensive or the sponsor covenant worsens/defaults. These scenarios may lead to a change in the objective. For each alternative objective, the scheme may be in a far better position with some or all of the longevity risks already manged.

What's the right longevity hedging solution – pensioner buy-in or a longevity swap?

Trustees and corporate sponsors should work closely with advisers to undertake a strategic analysis of their options. The answer as to how longevity should be hedged can be very scheme specific and not just based on quantitative analysis – softer factors such as the trustee board's views on complexity are as important.

What does this mean for the insurance markets?

As more and more schemes firm up their long-term objective, their journey plan to achieve this and make progress against those plans, the insurance market is expected to see increased demand for buy-ins and longevity swaps. As longevity swaps can remove more longevity risk than a buy-in for a given amount of capital, we think that there is also likely to be increased use of longevity swaps by small- and medium-sized schemes.

What should I do?

There is no time like the present. Develop the long-term objective – it is the foundation for clarifying the journey plan to deliver the best outcomes for members. As part of that consider how to tackle your significant actuarial risks such as longevity, especially if you have already started to tackle investment exposures.

Spotlight on: mortality trends

Cobus Daneel

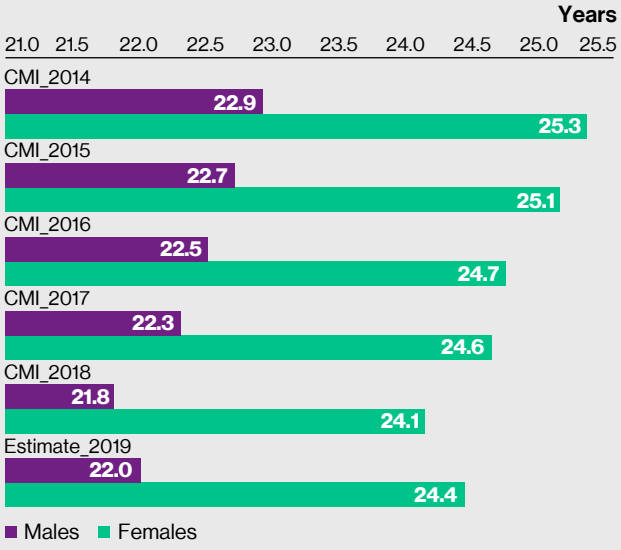
Jamie Jones

Cobus Daneel and Jamie Jones are members of Willis Towers Watson's team of thought leaders on mortality and longevity. In this article they consider recent trends in longevity and how this impacts on schemes looking to hedge longevity risk.

Decades of annual improvements in longevity have stalled in recent years, with few or no improvements in mortality rates since 2011. Many schemes have seen this reflected in their funding valuations, with liabilities reducing as longevity expectations are updated to reflect recent experience. Indeed, a scheme which carried out a valuation in 2019 using the latest improvement model available, the CMI_2018 model, would have seen life expectancies at age 65 falling by around a year compared to their previous triennial valuation, which likely would have been based on the CMI_2015 model. All else being equal, this may have reduced liabilities by about 4% – 5%.

However, mortality experience in 2019 bucked this trend, which will result in life expectancies increasing by two to three months with the release of the CMI's next improvement model – the first increase for around six years (see *Figure 6*). Is this just a one-off year for mortality improvements, or is it the start of a return to the growth of life expectancies overall?

Figure 6. **Cohort life expectancies for males and females from the CMI Mortality Projections Model**



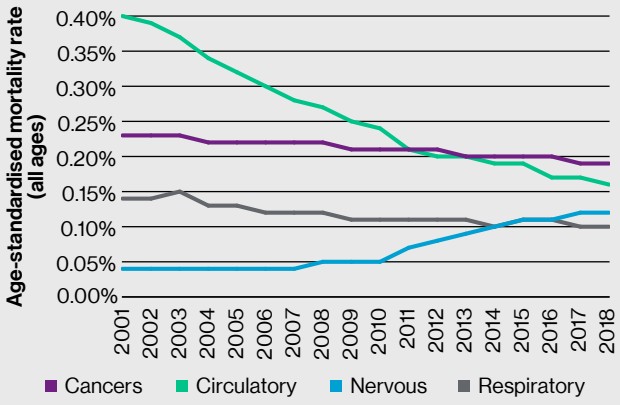
Source: Willis Towers Watson, December 2019

What caused the slowdown?

Many explanations have been given for the downturn in improvements this decade. Many are quick to point to austerity measures implemented since the 2008 financial crisis or to particularly cold winters (who can forget the 'Beast from the East')? However, to better understand the changes, it is useful to investigate mortality at its source: the cause of death (see *Figure 7*).

From 2001 to 2010 mortality rates saw dramatic reductions due to improvements in treatment and prevention of respiratory, cancer and particularly circulatory diseases, allowing people to live longer. However, in this decade we have seen both a slowdown in these improvements and an increase in the number of deaths from nervous diseases such as Alzheimer's and dementia, leading to little improvement overall. The increase in nervous diseases is also an emerging key driver of future mortality rates. Ultimately future longevity will be driven by our ability to treat and prevent the most common diseases that kill us all.

Figure 7. **Age-standardised mortality rates by main cause of death – males and females in England and Wales**



Source: ONS 2018 deaths registration publication – Table 7 (age-standardised death rates by underlying cause and sex – standardised to the European Standard Population)

Growing disparity in life expectancies

Analysis by the Office of National Statistics (ONS) identifies that the gap in average life expectancy by income has increased in recent years. While there are various theories as to why this is the case, the reality is that most defined benefit (DB) pension scheme members enjoy higher-than-average income and consequently have experienced higher longevity improvements than the general population.

We will have to wait to see if the 2019 mortality experience is a one-off or the start of a new trend. However, the combination of reducing death rates and higher longevity improvements among DB pension scheme members is likely to lead insurance and reinsurance markets to reverse the recent trend of improving pricing. Unless there is evidence that these reduced death rates are a temporary phenomenon we anticipate prices increasing over the coming year.

Case study: a ground-breaking £7 billion longevity swap for the HSBC Bank (UK) Pension Scheme, June 2019

After working with the Trustee since 2016 to consider longevity risk in the Scheme and the approaches available for managing it in the context of the Scheme's overall de-risking journey, Willis Towers Watson was appointed in 2018 as lead adviser on a potential longevity swap to cover around £3 billion of the Scheme's pensioner liabilities. Through intelligent negotiations and effective engagement with the market, we were able to obtain significant reductions in pricing so that a larger £7 billion deal became affordable for the Trustee, helping to mitigate a substantial part of the Scheme's overall longevity risk at a very attractive price and on market-leading terms.

Experience at large risk transfer deals:

A £7 billion deal was executed in June 2019 with the Prudential Insurance Company of America (PICA), becoming the second largest UK longevity risk transfer ever completed, following the BT Pension Scheme longevity swap in 2014 on which Willis Towers Watson was also the sole adviser. Willis Towers Watson has led over half of all public domain longevity swaps and 75% of the longevity swaps completed in 2018 and 2019.

Effective market engagement:

Assessment of the Scheme's longevity risk allowed the Trustee to track the risk against market pricing. This enabled the Trustee to seize the market opportunity that presented itself. In addition at outset, we established a step-by-step timeline for approaching the market, with clear objectives and milestones. Consequently the reinsurers had the confidence of clear timeframes and our client was primed to make quick decisions as and when required.

Intelligently negotiated pricing:

We scrutinised the pricing received from each reinsurer in the process and challenged them on specific elements of their pricing assumptions. As a result of this and the significant levels of competition in the market for this prestigious deal, we were able to negotiate price reductions of up to 3% across the shortlisted insurers.

Innovative solution:

We advised the Trustee on the range of options for accessing the longevity swap market. The Trustee decided that the preferred solution was to set up a Bank-owned captive insurer, using the Bank's existing infrastructure in Bermuda to maximise efficiency. This was the first-ever pension scheme longevity swap to be implemented through a Bermudan insurance captive. Willis Towers Watson is the only adviser to have led public domain transactions using all the available structures.

Working with multiple stakeholders:

In addition to the Trustee and PICA, we worked with the Bank, the Captive, administrators and various legal advisers to help our client agree the terms and the ongoing operational structure for this market-leading deal.

Through intelligent negotiations and effective engagement with the market, we were able to obtain significant reductions in pricing so that a larger £7 billion deal became affordable for the Trustee, helping to mitigate a substantial part of the Scheme's overall longevity risk at a very attractive price and on market-leading terms.

Tips for a well-run process

Suzanne Vaughan

In light of the record-breaking volume of liability secured with insurers in 2019 and the expectation that this demand will continue into 2020, schemes looking to bring transactions to market will need to work hard to stand out from the crowd as they compete for insurers' limited resources. Suzanne Vaughan reflects on the key lessons of 2019 that schemes can leverage to ensure a well-run process.

In order to get the best deal with any purchase (be that a new home, new car or holiday market-stall trinket) it's always beneficial to the purchaser when supply outweighs demand. 2019 saw a fundamental shift in bulk annuity market demand, with a record-breaking volume of transactions written: over £40 billion, three times larger than anything seen up until 2018 when the then record-breaking £24 billion was written. This uptick in demand was caused by improved scheme funding levels (from strong asset performance and lower-than-expected increases in life expectancy) at the same time as we saw some very attractive pricing from insurers. We believe this level of demand will continue into 2020 (at the time of writing, insurers are telling us they anticipate quoting on only one in every four cases), so schemes wishing to optimise pricing will need to ensure they stand out from the crowd.

What are the key lessons we can take from 2019?

Get the basics right

When insurers decide which case to quote on, one of the key factors they consider is how likely they believe the deal is to trade. With this in mind a few simple steps are critically important:

Data – provide clean and complete data, including collecting up-to-date marital information, both marital status and spouse's date of birth. As well as demonstrating to the insurer that this is likely to be a more efficient transaction, it also removes any concern over aspects open to misinterpretation across different insurers, leading in turn to an uneven playing field.

Benefit Specification – engage legal support early in the process so that the benefit specification (which summarises the member benefits to be secured) is accurate and complete at outset. This not only removes risk in the insurers' eyes of something being uncovered later in the process that means the deal is no longer feasible but also provides a demonstration of the upfront investment by the scheme to the deal.

Aligned trustee and sponsor – demonstrating both trustee and sponsor commitment to the transaction gives the insurer confidence that both parties are aligned. Setting clear, joint objectives with appropriate governance in place and suitable delegated authority is critically important. In 75% of the projects we lead a joint working group is established. This is a great way to demonstrate this alignment, agree joint objectives and go/no-go criteria upfront.

While none of the above steps are new, they have become even more important in achieving a successful outcome in a world of greater competition from other schemes. What's more, they can largely be completed well in advance of approaching the market, helping you grab any pricing opportunities.

Changing behaviour in light of the supply/demand shift

2019's marked increase in demand caused several behavioural changes among insurers and those taking bulk annuity deals to market.

So what are the lessons we can learn for future processes and what are the potential pitfalls to avoid?

Sharper focus on the "take to the market" proposition – by this, I mean a greater investment in the structuring of the subset of membership and benefits to be placed in the market for quotation. Of course there's a delicate balance to be struck here between appearing attractive to insurers and gaining maximum value and risk reduction for a scheme.

In 2019 we saw top slicing (the term for securing a subset of pensioner members with the highest liability) fall out of favour with insurers, as they began to decline more of these cases and increase pricing because of the concentration of deals written to date. Instead those schemes looking to secure a subset of their membership as an overall scheme investment moved to other selection approaches, such as every "N"th member selection, with certain restrictions and parameters. In the selection of these subsets, we saw an increase in upfront insurer engagement, with specific consideration of the potential onward pricing implications for the insurer's own reinsurance terms, in order to secure best pricing and maximise insurer engagement.

The case studies below give examples of how membership and benefits were considered to maximise potential value to the scheme.

Case study:
Global chemicals company, £235 million buy-in

Our client's desire for a buy-in arose primarily because they were looking to de-risk their portfolio as they were ahead of journey plan. They had already maximised their exposure to the other de-risked asset classes held and were looking for an alternative. Having considered other options, they concluded a buy-in was an appropriate de-risked class to invest c10% of the fund's assets and appointed Willis Towers Watson as transaction adviser to lead the process.

The subset of pensioners for the buy-in was selected following consultation with the insurer market, with careful consideration of the likely impact on the insurers' own reinsurance arrangements. A key requirement from our client was that any transaction did not unduly bias the residual membership for further transactions, something that is important to consider in any subset selection. A clear pricing target was set by the Joint Working Group in advance of going to market.

The structuring of the deal was particularly well received by the insurance market, with seven of the eight insurers active in the market quoting on the transaction, leading to strong competitive tension in the process. The Trustee commented that "the time taken to consider carefully the liabilities to take to market truly paid off, with such broad coverage of the insurance market".

The resulting transaction was secured at a price some £10 million below target.

"The time taken to consider carefully the liabilities to take to market truly paid off, with such broad coverage of the insurance market."

Case study:
Multinational vehicle manufacturer, £135 million buy-in

We had worked closely with the Trustee to improve the Plan's funding level towards the long-term target of buyout. We were appointed as transaction adviser and throughout the process we ensured that the Trustee and Company understood each other's objectives and aligned goals so as to ensure the project proceeded quickly and smoothly. We also led the project management from start to finish across the more than ten parties who were key to the project.

In considering the benefits to be secured, we were able to extract every last penny of value by taking advantage of disconnections between insurer pricing assumptions and "real world" assumptions to negotiate uncapped RPI pension increases at no additional cost to the Plan's standard capped RPI indexation – this was worth some 3% of the premium.

We provided strong support to the Trustee, guiding them through the transaction to achieve what the Chair described as "a great result in an amazing timeframe", with the contract signed less than five months after the Request for Quotation went to market. Careful project management meant we front-end loaded much of the work so as to compress timescales.

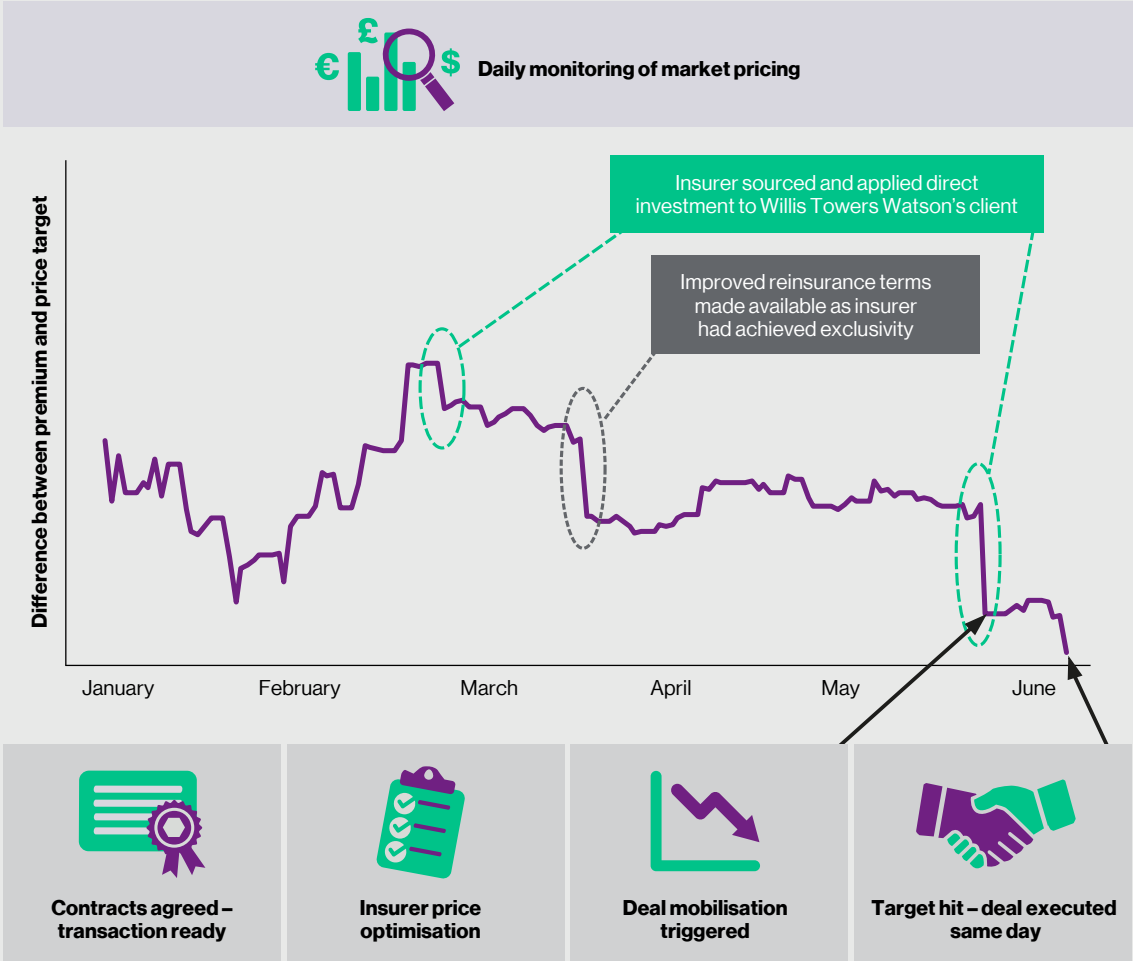
"A great result in an amazing timeframe."

Target price set in advance – Setting a target price within which the scheme will transact at outset has some real advantages. First it helps ensure that all parties are aligned in their views and also provides robust testing on the feasibility of any transaction, before time and expense is incurred on the full process. We very much encourage the setting of a target, doing so (even without then explicitly sharing this with the insurer market) helps provide comfort that appropriate due diligence has been completed before formally launching to market and it can also provide confidence that the transaction price is at a competitive level even if not all market participants have quoted.

However, it is worth being mindful of the potential consequences should the agreed target be shared openly with insurers at the wrong time. Although creating a clear guideline to insurers is viewed very favourably, it does allow them insight into your affordability and value-for-money measures, which can be incredibly valuable in guiding their negotiation tactics at later stages of the process.

Flexibility in timing of execution – Flexibility on timescales can be a real advantage in a bulk annuity transaction. The example in *Figure 8* is taken from our work with a global financial company, where Willis Towers Watson's Asset Liability Suite software was shared with the selected insurer, with a target price set for the transaction and contracts agreed in advance. This flexibility of timescale allowed the insurer time to optimise their pricing, in the knowledge the deal was theirs should they hit target price.

Figure 8. **Monitoring market pricing using Willis Towers Watson's Asset Liability Suite**

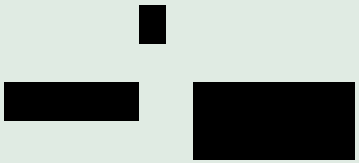


Case study:
An investment management company, £350 million buy-in

Here our client was initially considering insuring a subset of the overall pensioner population but opted to secure the full pensioner population as pricing received was far better than anticipated. Working closely with the Trustee and Sponsor as well as actuarial, investment and administration advisers, we were able to respond quickly to the favourable market opportunity presented.

Efficiencies were gained in the transaction by jointly reflecting the upcoming investment review as part of the process, allowing a broader selection of assets to consider for transfer "in-specie" to the insurer, reducing associated transaction costs.

Comfort side letters were valuable at contracting as the Trustee wished acknowledgement of an aspect which the insurer was unable and unwilling to provide in their contract. However, a mutually agreeable position was reached with the use of a comfort side letter.



Reacting to opportune pricing – Throughout 2019, with some particularly favourable pricing, we saw several cases where the trustee and sponsor responded quickly, rethinking their plans for a partial pensioner buy-in, instead securing an increased proportion of pensioners or even a full buyout. Having a robust governance structure set up in the early stages of the project allows schemes to be fleet of foot and to lock in to particularly favourable conditions if they present themselves as part of the process. Here strong project management can prove incredibly valuable as actuarial, investment and administration advisers all need to work closely together to respond to the changing structure of the transaction.

Streamlined approach to smaller schemes – With a number of insurers focused on large deals, some smaller schemes find it difficult to obtain full market interest. One way we have seen this mitigated is by using a streamlined offering such as the Willis Towers Watson's Streamlined Bulk Annuity Service and 2019 saw substantial growth in this area.

This service was designed to counter and mitigate the above challenge, 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 better as expenses are kept low for them.

Insurer desire for earlier exclusivity – Through 2019 we observed an increased desire on the part of some insurers for schemes to commit to working exclusively with a single insurer much earlier in the quotation process. Moving into earlier exclusivity makes it much more likely that the insurer will secure the transaction, rendering the deal more favourable for them. From the scheme's perspective, the theory goes that if an insurer is certain of transacting assuming a certain pricing threshold is achieved, their asset and reinsurance teams will work hard to meet this target and so ultimately better pricing will be achieved than if a wider market competitive process had been run.

Some insurers will seek to encourage this behaviour by offering to quote only if a scheme is prepared to reduce the field of participating insurers. This risks reducing the competitive tension in the bulk annuity process and has to be carefully weighed up against the alternative approaches open to the scheme. Before making a decision schemes should consider several factors, such as the number of insurers likely to bid, pricing indications from that insurer and the extent to which non-pricing features offered by that insurer make it a particularly favourable counterparty to the scheme.

The right decision here varies case by case, but there's a general point to be made about the benefit of being prepared, knowing your target price in advance and having access to strong market intelligence on current pricing levels achievable across the market.

Your scheme transaction

If you are considering bringing a transaction to market in the not-too-distant future, I would encourage you to get started today. Make sure the basics – data and legally reviewed benefit specifications – are nailed down and form a joint working group to align scheme and sponsor objectives. Reflect on the 2019 change in behaviours in light of the supply/demand shift, paying particular attention to your own take-to-market proposition and project plan. I am sure 2020 will prove to be yet another fascinating year in the de-risking arena and wish you all the best in ensuring yours is a case that stands out from the crowd.

Interview with Lincoln Pensions

Will Griffiths

Adolfo Aponte, Lincoln Pensions

Lincoln Pensions has been providing covenant advice to pension schemes for over a decade and, for the last eight years, it has been advising pension schemes on the financial robustness of insurers offering bulk annuities.

In this interview, Will Griffiths talks to Adolfo Aponte about another busy year for Lincoln Pensions in the bulk annuity market and where Adolfo thinks insurer covenant advice can add real value.

Q How does Lincoln Pensions go about an insurer covenant review?

A "Our focus is to ensure that trustees and sponsors can actively evaluate any trade-off between the price of an annuity policy and the level of security offered by the insurance provider, noting that the lowest price may not always equate to the strongest counterparty.

We achieve this by assessing an insurer's capabilities across seven key factors, ranging from the robustness of the solvency position to the risk management and governance culture. This allows trustees to visualise an insurer's risk profile. Our analysis is complemented by the ongoing dialogue we maintain with the insurers around their financial standing and broader strategy."

Q What do you see as your key differentiators compared to others who provide similar services?

A "Our approach seeks to help trustees (and sponsors) that are caught by the industry jargon; we want to enable them to examine an insurer's risk profile in a way that can be clearly understood. Part of what we do involves presenting the results of our analysis graphically. This approach offers a consistent framework to compare the relative strength of several insurers in the brokering process – we believe we are the only adviser to do this.

We also focus very much on forward-looking advice, which is important given the annuity policies will be held for decades, and as a result cover topics such as the impact of new business on insurers, possible regulatory developments and how an insurer's strategy might develop."

Q What would you say in response to the challenge that an insurer covenant review is not necessary given the regulatory environment for insurers?

A "There is sometimes a misconception about what insurance is designed to offer – insurance is rightly viewed as the gold standard but the regime does not purport to be risk-free. As with all insurance products, each annuity policy will offer a trade-off between the premium paid and the level of protection received. The regulatory regime retains flexibility to enable investors in this sector to make a return on their capital and different insurers will go about achieving this in different ways. Understanding these differences is key.

Life insurance failures are very rare but any such cases tend to be high-profile and get meticulously scrutinised by regulators, politicians and the media. They can also cause unnecessary anxiety and concern among policyholders, trustees and sponsors. So good governance plays an important role and trustees will want to demonstrate that they have fully considered the trade-offs inherent between price and security."

"For most insurers, we are expecting solvency levels to remain robust going into 2020. Then, over the medium term, we expect the insurance industry to come under greater scrutiny given its rapid expansion."

Q At which stage are you typically brought into a process?

A "Originally we used to be brought in at the later stages, almost as a tick-box exercise focusing just on the insurer the trustees had entered exclusivity with. More recently though we are asked to provide input in tandem with first-round bids; this enables trustees to compare bids on the basis of security, not only price, and also provides an opportunity for them to ask any outstanding questions of all the insurers before selecting one to grant exclusivity to. This is also the approach that will be offered under the Willis Towers Watson Streamlined Bulk Annuity Service."

Q What are your predictions for the bulk annuity market from a covenant perspective?

A "For most insurers, we are expecting solvency levels to remain robust going into 2020. Then, over the medium term, we expect the insurance industry to come under greater scrutiny given its rapid expansion. In this context, it is also interesting to note that the current regulatory regime has not yet been tested through a full business cycle (it came into force in 2016). A pick-up in credit defaults, for example, could well hamper the industry's capacity to continue to write new business at the levels we have seen over the last year, leaving schemes that have selected "buyout" as their end-game target waiting for the insurance industry to turn the page."

Overview of Lincoln Pensions

- One of the largest covenant advisers in the general pensions market with a team of over 50 people
- Over the last two years have advised on bulk annuities for over £16 billion of liabilities
- A specialist team focused on identifying the risk profile of insurers active in the bulk annuity market
- The team has a wide range of backgrounds including corporate financiers, accountants, actuaries, lawyers and former regulators

Willis Towers Watson's Streamlined Bulk Annuity Service

- Brings together Willis Towers Watson, Burges Salmon and Lincoln Pensions to deliver transaction, legal and financial strength services at a competitive fixed fee
- Makes transactions straightforward for trustees and insurers, generating good insurer engagement
- We have used our combined market presence and bulk purchasing power to pre-negotiate terms which are better than insurer standard
- Faster transaction times mean an extra opportunity to capture attractive insurer pricing
- Has been used successfully on more than 20 bulk annuity transactions, with aggregate premiums of more than £1 billion

Spotlight on: GMP equalisation – insurer views

Lucy Wilson

With long-term journey planning and GMP issues identified as the top two current issues for pension scheme decision makers in a recent Wills Towers Watson survey[1], it's no surprise that the interaction of bulk annuities with GMP equalisation is a serious consideration for a growing number of schemes. In this article Lucy Wilson examines insurers' latest views on this key topic.

Many trustees and sponsors have already taken their first steps on their GMP equalisation journey. But, with more guidance expected in the future, many pension schemes are choosing to wait before deciding on their approach to equalising their benefits. However for those schemes looking to buyout, particularly in the short term, their choice of equalisation methodology will be an important consideration. Insurers require GMP equalisation to be completed before the contract moves to buyout and they issue individual policies to members. It's vital that the buyout insurer is on-board with the methodology and processes followed to ensure smooth sailing later down the line.

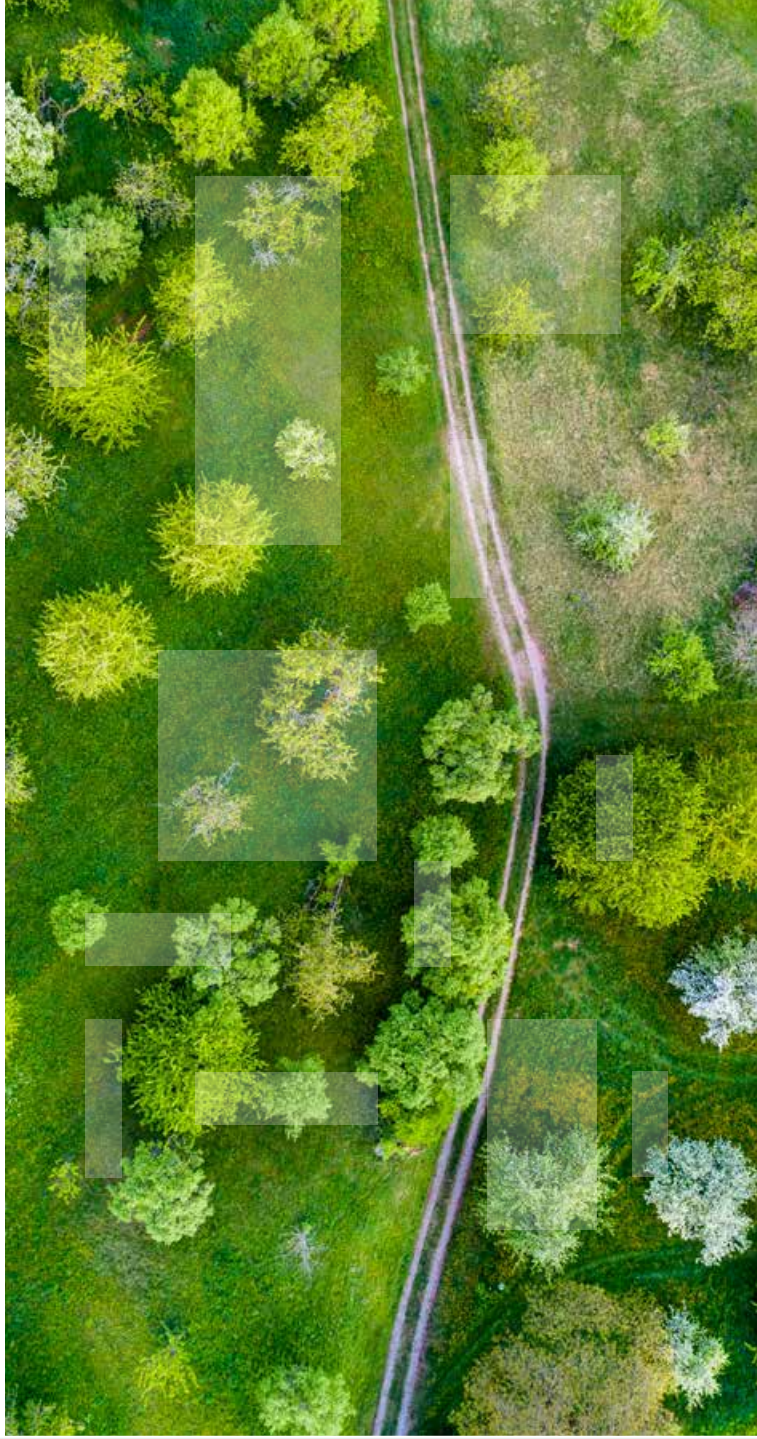
As is the case for trustees, the main determinant of whether a particular methodology can be offered is their administration constraints. In addition, the more straightforward the benefits, the easier it is for the insurer to ultimately provide these to members.

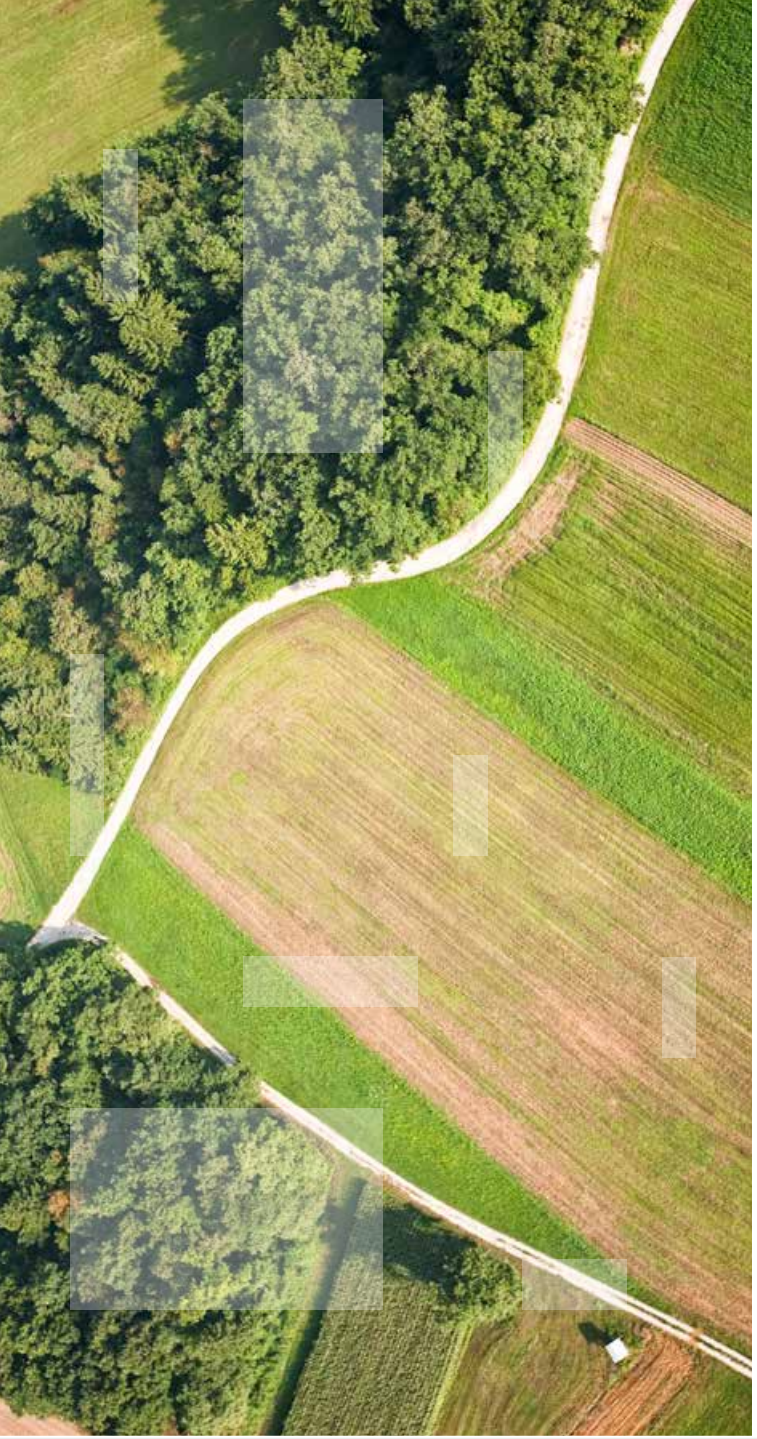
Perhaps unsurprisingly, given the removal of the complications of GMP benefits or the need for complex administration set-ups, all the insurers will offer method D2 universally, with the majority stating a strong preference for it.

Acceptable methodologies for buyout

B	C1	C2	D2
"Better of" on a year-by-year basis	"Better of" on a cumulative basis, no interest	"Better of" on a cumulative basis, with interest	GMP conversion on a value basis
Dual records	Dual/triple records	Dual/triple records	Single records

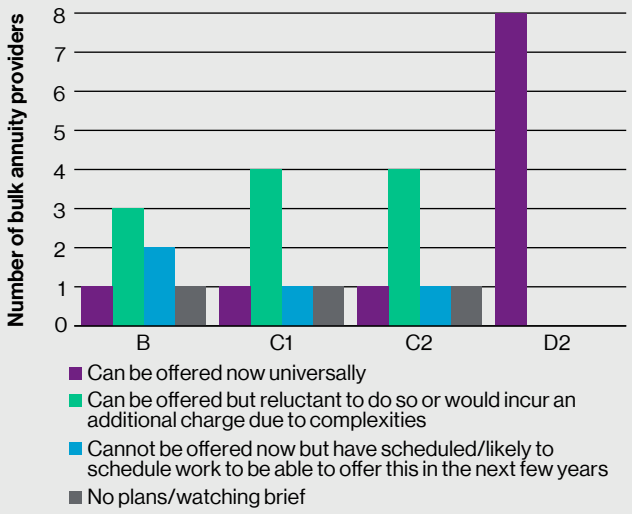
[1]Source: Willis Towers Watson Emerging Trends in DB Survey 2019





As can be seen from *Figure 9*, other methodologies may be used, with insurers typically working to be able to administer more complicated benefits in future, although additional charges may be levied to schemes requiring this for the added complexities.

Figure 9. **Equalisation methodologies supported by bulk annuity providers**



Source: Willis Towers Watson, September 2019

What about buy-ins?

Schemes can enter into buy-ins without having equalised GMPs. Typically, we would negotiate clauses into contracts that allow benefits to be amended prior to buyout, incorporating changes due to equalisation.

100%
of insurers willing to transact buy-ins without the trustees having yet decided their equalisation approach

However, the insurer will need to agree to any benefit changes, particularly where this could affect administration complexity. Schemes considering, or which have already transacted, buy-ins should factor insurers' views on appropriate methodology into their GMP considerations.

Discussion is key

Insurers' views on GMP equalisation, and their administration capabilities, are evolving. The key for schemes is to discuss the proposed approaches with insurers to future-proof their contracts. Even where an insurer's reaction is initially that a method doesn't work for them, insurers are typically willing to innovate for the right case.

Consolidation: one year on

Tom Ashworth

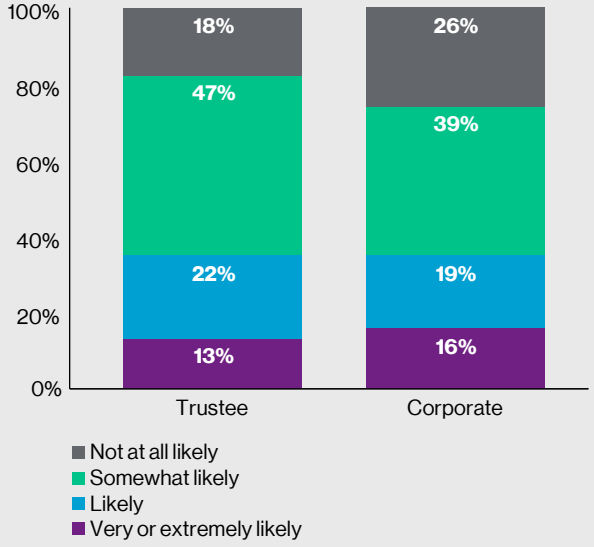
Tom Ashworth takes a look at some of the benefits of commercial consolidation, where it may be a viable option for a scheme, the circumstances where it may not be appropriate and the reasons why or why not.

We are now nearly 12 months on from the closure of the consultation on the framework for authorising and regulating commercial consolidators and (at the time of writing) the government has yet to settle on the regulatory regime.

The delayed timetable has been in part caused by the unexpected general election at the end of 2019, leading to the dissolution of parliament and uncertainty regarding the future government and pensions minister. With the dust now settled, we expect further clarity around the authorisation regime in early 2020, which could lead to an uptick in activity.

This delayed response has given market participants time to further consider commercial consolidators as a concept and the scenarios in which they may be right for their scheme. Willis Towers Watson's recent survey showed that the industry sees consolidation playing an important future role in the pensions arena (see *Figure 10*).

Figure 10. **How likely do you think it is that a significant number of schemes will be absorbed by commercial consolidators in the next five years?**



Source: Willis Towers Watson

To date, two commercial consolidators have launched publicly, Clara-Pensions and The Pension SuperFund, with others considering following suit. The two existing consolidators operate with different structures. Clara-Pensions promotes itself as a bridge to buyout, with The Pension SuperFund a long-term run-off solution (see *Figure 11*).

Commercial consolidation is not equivalent to a buyout with an insurer underpinned by the insurance regime, but nor does it purport to be. It offers a different solution underpinned by the pensions regime (and the Pensions Protection Fund), with a higher level of risk than the insurance regime, but a lower (expected) entry cost.

Trustees will be faced with the question, is this cash injection today (along with the other benefits offered by commercial consolidators) better than the status quo, or other alternatives? (see *Figure 12*).

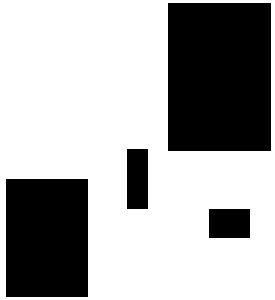


Figure 11. **Comparison of Clara-Pensions and The Pension SuperFund structure**

	Clara-Pensions	The Pension SuperFund
Long-term objective	Targets buyout for each scheme in 5-10 years	Fund runs off in the long-term
Sectionalised?	Yes. Each scheme placed in own 'cell'	No. Single fund for all received schemes
Returns	Clara investors only receive returns once buyout achieved	Pension SuperFund investors receive regular returns, contingent on maintaining a minimum funding level. These returns are shared with members via a member "top-up"

What are commercial consolidators?

- Commercial consolidators are vehicles into which a pension scheme can transfer responsibility for paying benefits.
- To enable this clean break, the sponsor will typically make a cash injection.
- The commercial consolidator will also inject capital, in much the same way as insurers in a bulk annuity transaction, although to a lower level.
- The commercial consolidator is then responsible for running and meeting the liabilities of the scheme, and a new board of trustees provided by the consolidator will be responsible for scheme governance. A consolidator therefore replaces the unknown future value of the sponsor covenant, with a monetary amount of capital on day one.

Figure 12. **Key considerations when assessing a commercial consolidator to the status quo**

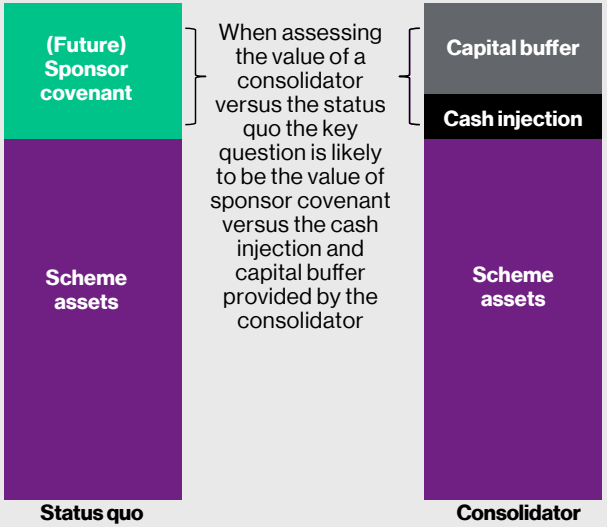
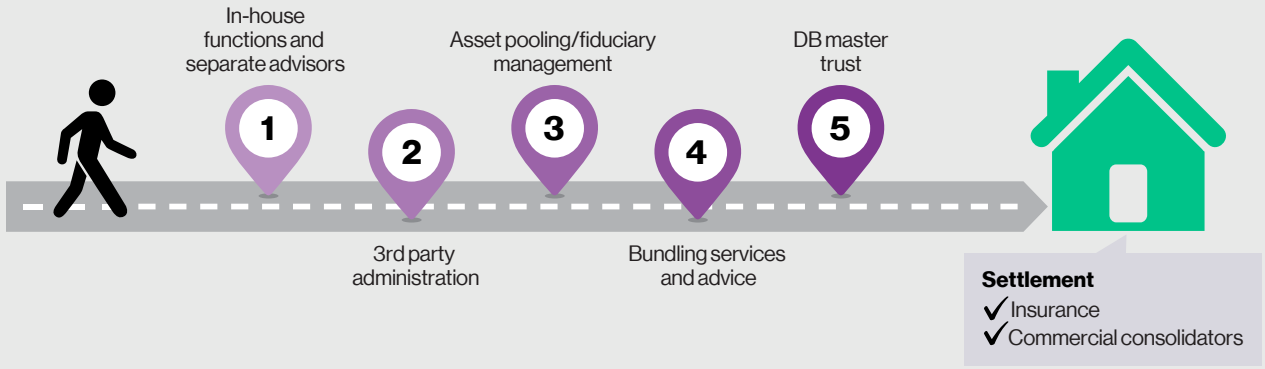


Figure 13. **Increasing levels of consolidation in DB pensions**



What are the benefits of consolidation?

Consolidation is not a new concept to the pensions industry. *Figure 13* shows the various forms of consolidation that already exist in the pensions industry, from bundled advisers and fiduciary management through to DB master trusts and bulk annuities. As with any form of consolidation, commercial consolidators look to offer economies of scale.

For commercial consolidators these include lower running costs and access to a wider range of specialist providers. Greater access to investment opportunities provide the prospect of achieving better outcomes for members with a potentially improved risk/return profile, relative to the status quo. As entities built for the sole purpose of running pension schemes, there will be high-quality governance requirements with dedicated professional processes enabling more effective decision making and high-quality member service.

In addition, commercial consolidators also provide a settlement option, thereby providing certainty of costs for the sponsor. As commercial consolidators are not subject to the insurance regime, their capital requirements are expected to be lower than for an insurer, resulting in a lower price to settle liabilities (although with that, a lower level of security). This is particularly expected to be the case for schemes with a high proportion of deferred members, where the capital requirement under the insurance regime is more onerous.

Schemes should only transact with a commercial consolidator if it is in the interests of members. However, given the extra capital, both from the commercial consolidators backing each deal and the (accelerated) payment from the sponsor, member security could be improved relative to the status quo.

So what are the instances in which passing liabilities to a commercial consolidator may make sense for your scheme?

The original Green Paper covering consolidation issued in February 2017 noted small schemes would benefit the most from the economies of scale offered through consolidation. However, in the short-term, we expect commercial consolidators will need to focus primarily (but not exclusively) on larger deals as they look to build scale.

Scenarios where the commercial consolidation market could appear attractive are for:

- well-funded schemes (relative to a consolidator premium) with a limited value placed on the direct sponsor covenant
- schemes where a limited cash injection is available to pay to the consolidator, which is not sufficient to fund full buyout, and where the trustee has reservations about the sponsor's future (long-term) ability to back the scheme; or
- schemes which are large compared to their sponsor. Even if well-funded, should experience lead to significant funding level reductions the capital buffer provided by the consolidator may be more likely to absorb this shock than the sponsor.

What are the drawbacks?

The key difficulty that schemes must overcome is assessing the primary feature of consolidation: replacement of the sponsor covenant with a monetary amount. In particular, trustees will need to consider if the level of extra cash and capital provided are better than the (unknown) future covenant of the sponsor. This will need careful consideration with legal, covenant and actuarial input.

A transfer to a consolidator is not without risk, although neither is any other option available to a scheme (including the status quo). Schemes will also need to consider softer factors such as views of members if ties with the sponsoring employer are severed and, the current 'early mover' risk as the market is in its infancy, although this could present pricing opportunities for some schemes.

Examples of where a consolidator solution may not be appropriate include schemes that:

- can afford to buyout with an insurer (either now or in the short- to medium term). Consolidation should not be viewed as a lower-cost alternative to buyout and should only be considered where buyout is not affordable; or
- are well funded with strong sponsors and transfer to a consolidator is not expected to improve member outcomes.

Summary

The overriding principle for trustees of defined benefit pension schemes is to improve expected member outcomes within the constraints of the scheme, sponsor and regulatory framework. Commercial consolidation offers another solution for schemes, where appropriate, to meet this objective while also discharging the sponsor of its responsibilities. We expect the development of the regulatory framework to help kick-start this market and we look forward to seeing how it develops over 2020.

Trustees will need to consider if the level of extra cash and capital provided are better than the (unknown) future covenant of the sponsor.

Where next for the longevity de-risking market?

Sadie Scaife

Sadie Scaife predicts what we can expect from the longevity hedging and bulk annuity markets in 2020.

1 Continuation of a very busy market

I expect a continuation of the very busy market which led to each of the last two years reaching record-breaking levels of business, with total volume of bulk annuity business of around £30 billion for 2020. Although I don't expect 2020 to break bulk annuity records in terms of total volume of business, I anticipate more transactions than in 2019, but fewer at the multibillion level which made 2019 exceptional. I think we could continue to see schemes that have previously completed a longevity swap transferring these to the bulk annuity insurer as part of a buy-in. I also expect a busy start to 2020 reflecting pent-up demand from schemes that have not been able to transact by the end of 2019.

So why do I expect the appetite for bulk annuities to continue? Scheme funding levels have generally trended upwards from a combination of positive asset returns and longevity gains and although we aren't anticipating longevity gains this year because of lighter death rates in 2019, this is acting as a reminder to schemes that the risk is still worth hedging, rather than dampening enthusiasm for transactions.

GMP projects will continue to take up valuable time and resources with pension schemes, but this need not hinder those schemes wanting to carry out a transaction at the same time.

2 Continuing insurer operational constraints

For the insurers, constraints caused by problems sourcing capital and assets will continue to be manageable at the market-wide level, although individual appetites will naturally rise and fall throughout the year.

Once again the main drivers of capacity will be operational – largely people – resources at the insurers, who will remain selective about the opportunities they choose to participate in. Insurers will want to see a clear plan to a transaction with all stakeholders engaged before they commit their resources, so it will continue to be the most prepared schemes who get the best outcomes in the market.

3 Possible shift in what schemes want to see from insurers?

As well as wanting the most competitive pricing, schemes will need to consider environmental, social and governance (ESG) issues in their selection criteria for an insurer, alongside security and brand. We expect this to receive increased future focus at beauty parades.

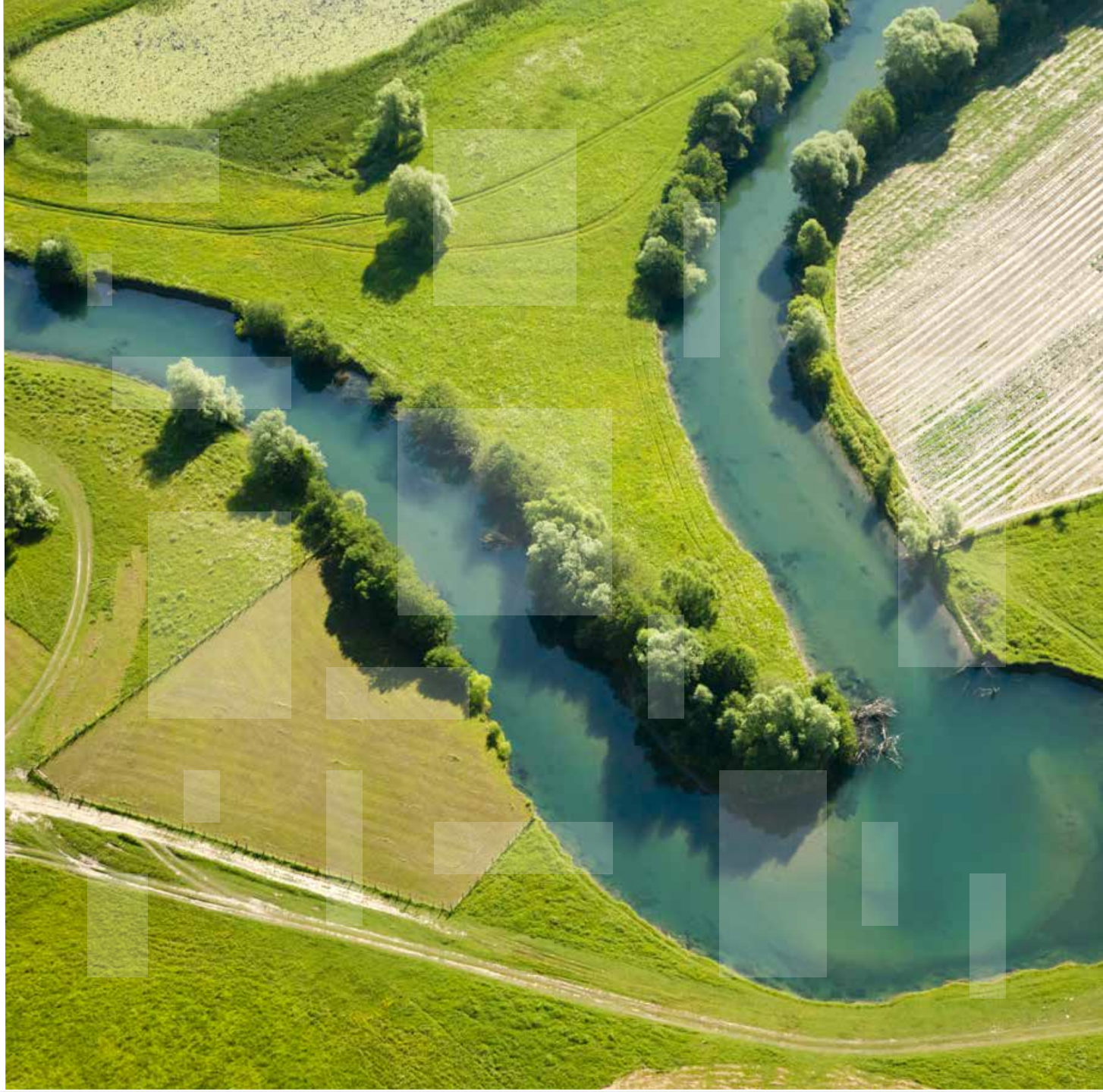
4 Bumper year for the longevity swap market

2020 will be a record-breaking year for the longevity swap market, with more swaps than in any previous year and total volumes of in excess of £25 billion. Transactions will be heavily weighted towards white-collar schemes, particularly in the first half of the year, opening up opportunities for blue-collar schemes as reinsurers who have already won business seek to diversify and others target schemes that better suit their preferred demographics.

Pension schemes will continue to use a variety of structures to access the reinsurance market, with some choosing to establish offshore insurers for this purpose while others will transact with the UK insurers, including some new names in this market.

5 Increase in the use of commercial consolidators

As Tom Ashworth alluded to on page 23, delays in the regulatory regime for the commercial consolidation market have meant that we haven't seen the level of activity we were expecting this time last year. However, I do expect that once the first few pension schemes have gone down this route others will follow. It's unclear at this stage how large this market could grow, but I think the additional end-game option for pension schemes is a useful addition.



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About Willis Towers Watson

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Our unique perspective allows us to see the critical intersections between talent, assets and ideas — the dynamic formula that drives business performance. Together, we unlock potential. Learn more at willistowerswatson.com.

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