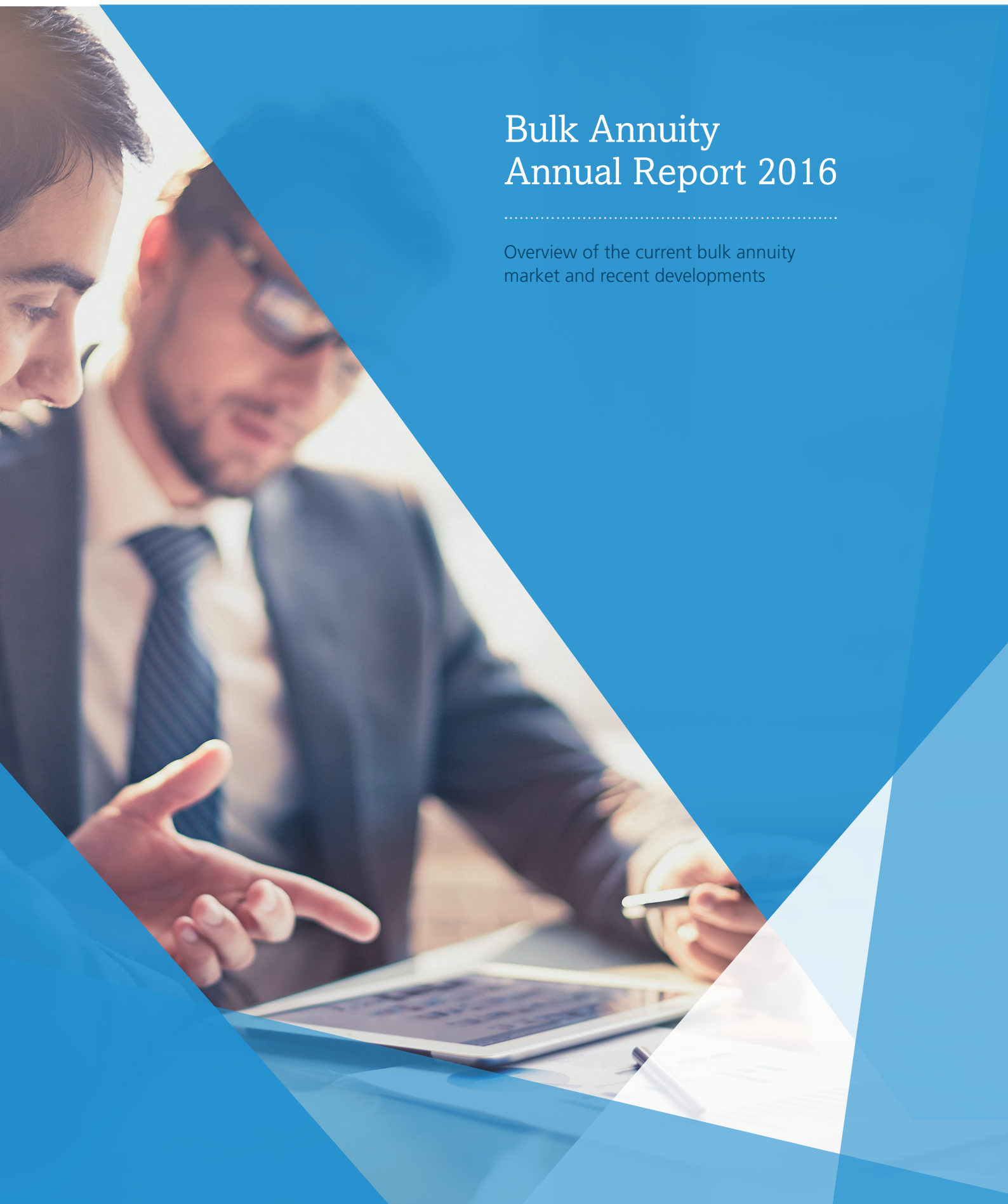


Bulk Annuity Annual Report 2016

Overview of the current bulk annuity
market and recent developments



INSURER VIEWPOINT

In preparing this report, we received feedback from the insurers active in the bulk annuity market. The feedback covered a range of questions gauging their views on certain key areas of the market and potential future developments. Their summarised responses are included throughout this report at the relevant points.

We would like to thank the following insurers for their participation:

- Aviva
- JRP Group*
- Legal & General
- Pension Insurance Corporation
- Prudential
- Rothesay Life
- Scottish Widows

* formed following the merger of Just Retirement and Partnership



In this report, we provide an overview of the current bulk annuity market and discuss the recent developments which will have had an impact for schemes looking to carry out a buy-in or buy-out transaction.

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Introduction

We highlight a number of key considerations for scheme trustees and sponsors seeking to transact in an efficient and cost-effective manner within this report. We have also sought the views of the insurers actively participating in the market on a range of issues and their responses are summarised throughout the report.

MARKET ACTIVITY

The bulk annuity market in 2015 comfortably exceeded £10 billion for the second year in a row, aided by a strong final quarter as several schemes sought to transact before the introduction of Solvency II. This increased level of activity compared with historic annual volumes (which have typically been of the order of £5-6 billion) clearly demonstrates the strengthening demand of pension schemes for insured de-risking solutions and the current ability of the market to satisfy this.

Activity in the first half of 2016 has been quieter, and it remains to be seen what impact the EU Referendum will have over the short to medium term. However, despite a climate of historically low gilt yields, the clear direction of travel for the vast majority of pension schemes has been towards further de-risking as they continue to mature. As part of this evolution, an increasing number of schemes are looking to the bulk annuity market to provide a fully matched asset – covering both the financial and demographic risks.

Overall, we would anticipate that market volumes will continue around these recently increased levels, albeit primarily dependent on the completion of several very large deals as was the case in 2014 and 2015. We would also expect a heightened focus on pensioner buy-in deals, or buy-out deals where the scheme has been relatively well hedged against interest rate risk, given the challenging funding environment facing schemes.

The medically underwritten bulk annuity market saw its strongest year in 2015. Since the first successful transactions in this market were completed at the end of 2012, the total volume of business completed now exceeds £2 billion. Medical underwriting has been especially effective for 'top-slicing' transactions where only the highest liability pensioners within a scheme are insured. 'Top-slicing' offers a scheme the ability to remove any concentration of longevity risk associated with these individuals – longevity risk is becoming an increasingly important issue in a low-yield environment and where schemes have already tended to reduce their level of investment risk.

Innovative variations in deal structuring, such as post-deal underwriting, have also helped to support the continued growth of the medically underwritten market. These features are likely to become more prevalent following the merger of the two leading specialists (Just Retirement and Partnership) in April 2016 to form JRP Group, and the resulting impact on direct market competition in this area.

EU REFERENDUM AND SOLVENCY II

Unsurprisingly, the result of the EU Referendum had an immediate effect on financial markets, and more generally has increased the ongoing level of uncertainty for schemes and prevailing market volatility. The impact for individual schemes will have varied markedly depending on their own specific circumstances. In particular, those schemes having a high degree of interest rate hedging already in place will have benefited from this protection.

Whilst the overall solvency position may have worsened for a large number of schemes, the position remains potentially attractive for schemes considering a full or partial pensioner buy-in transaction, for example through an exchange of their existing gilt holdings or other low risk assets. The greater volatility also increases the importance of monitoring the position closely to identify any opportunities which may arise. If there is an overseas corporate parent, the weakening of sterling following the EU Referendum may help to improve the transaction affordability where additional funding is required – we have already seen cases progress where the affordability of the potential transactions has improved as a result of the exchange rate changes.

Solvency II remains in its relatively early stages and insurers continue to refine their approaches in order to optimise their position and in turn support more competitive pricing. Under Solvency II, we have seen a wider variation in insurer pricing, particularly at the initial quotation stage and for deferred members. This reinforces the potential benefits of maximising the level of insurer participation and competition, both at the outset and also during the transaction process.

TRANSACTION PREPARATION

For those schemes considering a potential transaction in the short to medium term, it is more important than ever to be well prepared and position themselves as favourably as possible to the market. This is important for schemes generally, but especially for smaller schemes where the insurers' appetite and the range of potential providers has become increasingly restricted. It is essential for scheme trustees and sponsoring employers to take specialist advice to ensure that they are aware of all the options available and be in a position to make fully informed decisions in achieving their objectives.

In particular, the role of liability management exercises has become increasingly important for schemes, supported by the introduction of the pension freedoms in the April 2014 budget. Schemes of all sizes are able to implement actions which can help improve their financial position, either carried out as a one-off bulk exercise or as part of the ongoing retirement options for members. Our clients have successfully implemented these exercises (e.g. member transfer or pension increase exchange (PIE) exercises) to reduce the cost of an imminent transaction or as part of their de-risking strategy.

We would be delighted to discuss any of the issues raised in this report, or any other aspects of the bulk annuity market or de-risking more broadly, with you.

We hope that you find this report helpful.

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Buy-outs and buy-ins market activity

2015/16 ACTIVITY

The market showed another strong year in 2015, with total transaction volumes breaching £12 billion for the second consecutive year. Just under half of these transactions were completed in the final quarter as schemes looked to transact before the year end and the introduction of Solvency II.

The breakdown of transactions completed by the UK bulk annuity insurers with UK pension schemes over 2015 (and first half of 2016) was as follows:

	Number of transactions					
	2015					2016
	Q1	Q2	Q3	Q4	Total	H1 Total
Aviva	3	10	7	14	34	13
Canada Life	0	0	1	1	2	1
Just Retirement	5	7	6	18	36	note
Legal & General	10	17	11	14	52	9
Partnership	2	2	2	9	15	note
Pension Insurance Corporation	2	4	2	5	13	2
Prudential	0	2	2	2	6	0
Rothsay Life	0	1	1	2	4	0
Scottish Widows	0	0	0	1	1	3
Total	22	43	32	66	163	28

	Value of transactions (£million)						
	2015						2016
	Q1	Q2	Q3	Q4	Total	Average Transaction Value (£m)	H1 Total
Aviva	2	405	78	499	984	29	71
Canada Life	0	0	5	27	32	16	35
Just Retirement	93	161	104	598	956	27	note
Legal & General	644	502	92	739	1,977	38	641
Partnership	24	44	24	186	278	19	note
Pension Insurance Corporation	40	640	259	2,872	3,811	293	897
Prudential	0	1,170	317	21	1,508	251	0
Rothsay Life	0	675	1,600	63	2,338	585	0
Scottish Widows	0	0	0	400	400	400	884
Total	804	3,598	2,479	5,404	12,284	75	2,528

Source: Insurers
Note: Figures for JRP Group (formed following the merger of Just Retirement and Partnership are unavailable at time of publication

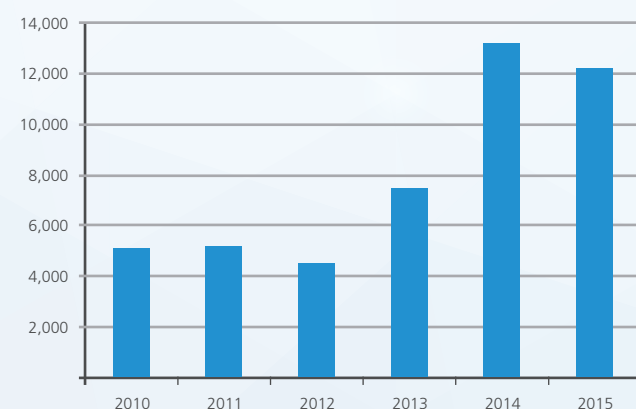
The total volume of business in 2015 of £12.3 billion was the second highest year on record, marginally less than the total of £13.2 billion in 2014.

As illustrated by the chart below, these two years represent a significant increase in activity relative to the previous years where the typical annual volume had been around £5-6 billion. However, these volumes also need to be considered in the context of the overall value of UK pension scheme liabilities which are in excess of £2 trillion, demonstrating the deals to date represent the proverbial tip of the iceberg when it comes to the scale of future demand for insurance solutions.

As was the case in 2014, a few very large transactions made a significant difference to the 2015 total. These included the £2.4 billion Philips Pension Scheme buy-out completed with Pension Insurance Corporation and the £1.6 billion Civil Aviation Authority Pension Scheme buy-in with Rothesay Life.

The total value of bulk annuity transactions (buy-in and buy-out) completed by UK insurers over the last few years is shown below.

VALUE OF TRANSACTIONS (£MILLION)



Source: Insurers

The absolute number of transactions completed in 2015 was slightly lower than 2014. This was partly due to the insurers getting to grips with Solvency II, the new regulatory regime for insurers. We have also found that insurers have become increasingly selective on which cases they are willing to quote for. This is particularly true for smaller schemes, who can sometimes struggle to get traction in the market. As a result, it is important that scheme trustees and sponsoring employers are well prepared when requesting quotes demonstrating their commitment to progressing the transaction.

MEDICAL UNDERWRITING

The growth of medical underwriting also increased markedly in 2015 – with medically underwritten transactions representing about 12% of the total value of business. As previously, Just Retirement and Partnership, the two specialist medical underwriting providers, were the main drivers behind the market, completing over 50 deals between them. However, Legal & General also completed a £230 million medically underwritten buy-in with the Kingfisher Pension Scheme in December – this is the largest medically underwritten deal to date.

Medical underwriting is discussed in more detail later in this report and was also the specific focus of our recent webinar which can be accessed below.

Medically Underwritten Webinar
<https://www.brighttalk.com/webcast/13587/200277>

FIRST HALF OF 2016

The first half of 2016 has been relatively subdued in terms of pension scheme transactions, as Solvency II beds in for the insurers and additional uncertainties have pervaded both in the run up and also following the EU Referendum. However, the impact of the vote on the financial markets has provided some opportunities, as demonstrated by the £750 million buy-in carried out by the ICI Pension Fund in July 2016.

Some providers have also completed significant transactions for annuity back books. In particular, the annuity book of Scottish Equitable, a subsidiary of Aegon, involved both a £6 billion deal with Rothesay Life and a £3 billion transaction with Legal & General. From the perspective of pension schemes, these deals represent potential competition for the bulk annuity insurers' appetite and capacity in the shorter term.

INSURER VIEWPOINT

In terms of possible future transaction volumes, assuming no fundamental change in financial market conditions, the insurers' general view was that annual transaction volumes in the near future (for example 2017) will only show a small increase compared to the level seen in 2015. However, the consensus view was that further into the future (for example in five years, 2021) transaction volumes will have increased, with some insurers remarking that annual volumes may be in excess of £20 billion.

The chart overleaf illustrates the insurers' views on certain significant factors which may positively influence the demand for bulk annuity transactions from pension schemes and their relative importance.

1 IS LESS IMPORTANT WHILE 5 IS MORE IMPORTANT



Unsurprisingly, an easing of market conditions was considered to be the factor which would have the greatest potential impact on the appetite of schemes. The development of the financial markets, particularly those key areas affecting insurer pricing and UK pension scheme funding, will be strongly impacted by the aftermath of the EU Referendum and the subsequent Bank of England interventions, political developments and trade negotiations.

MARKET PROVIDERS

There have been some significant changes to the provider landscape over the course of 2015 and the first half of 2016. The pension freedoms introduced in the April 2014 budget which removed the requirement to purchase an annuity, and the subsequent fall in demand for individual retail annuities, has been an important contributing factor underlying some of the changes, as well as the introduction of Solvency II.

Scottish Widows joined the bulk annuity market in 2015 and completed their first transaction in quarter four with a £400 million buy-in with the Wiggins Teape Pensions Scheme. Meanwhile, Canada Life also re-joined the market in 2015 and carried out their first transactions in 2015.

Prudential formally announced in August 2016 that they would no longer be participating in the bulk annuity market, having sign-posted their reduced appetite earlier in the year.

Within the medically underwritten market, Just Retirement and Partnership completed their merger in April 2016 to form JRP Group, the merged entity adopting the Just Retirement product offering including the capability of insuring deferreds.

LV=, who had previously considered an entry into the market in 2016, have confirmed that they will not be doing so, at least in the short term.

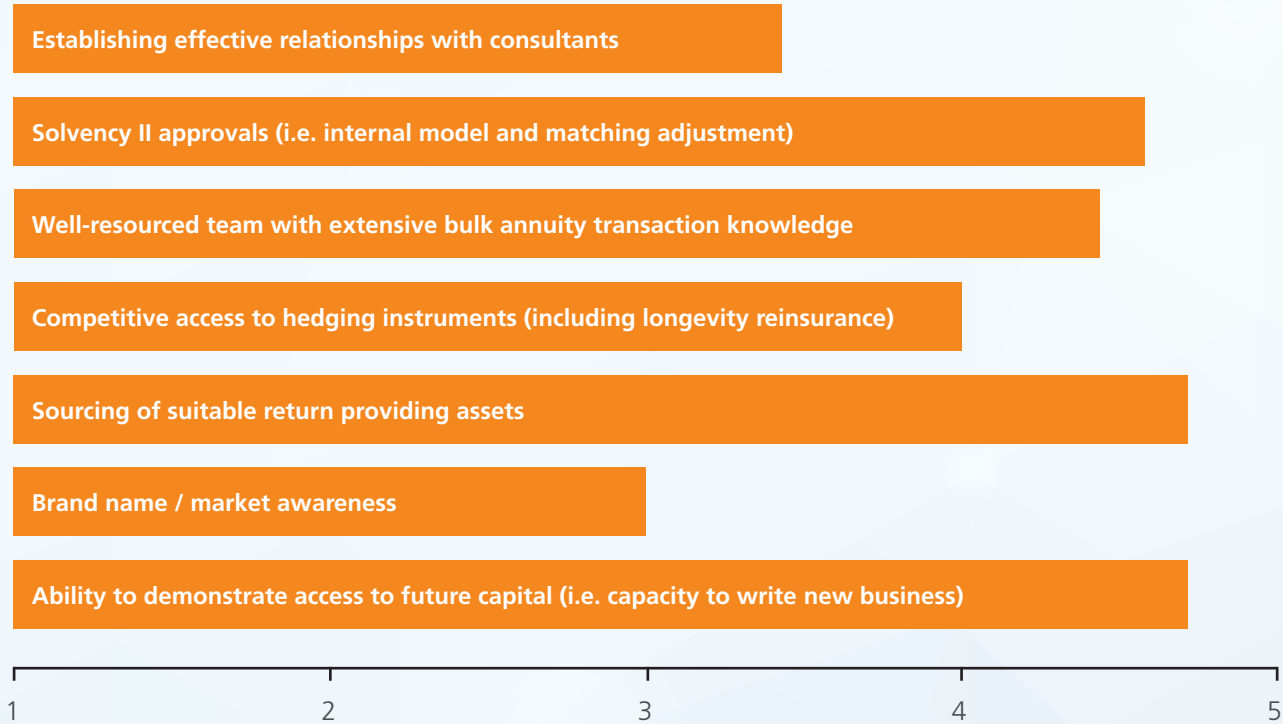
This means that at the time of writing there are seven insurers who are active in the market, although these insurers have differing preferences when assessing their appetite for a potential transaction depending on factors such as transaction size and liability profile.

INSURER VIEWPOINT

The general view of the insurers was that the number of active providers in the bulk annuity market was likely to remain broadly unchanged over the next couple of years. However, over a slightly longer time horizon (for example in five years) the vast majority believed that there was likely to be an increase in the number of providers, with the order of 10 to 11 insurers potentially being active in the market.

For any insurers looking to participate in the bulk annuity market, the following chart illustrates the insurers' view on the relative importance of a number of key factors for entering the market successfully. These primarily relate to the insurer's ability to achieve the necessary statutory approvals and efficient reserving position under Solvency II, as well as other drivers of competitive pricing such as sourcing suitable investment returns. All of the factors were deemed to be important to some extent by the insurers.

1 IS LESS IMPORTANT WHILE 5 IS MORE IMPORTANT



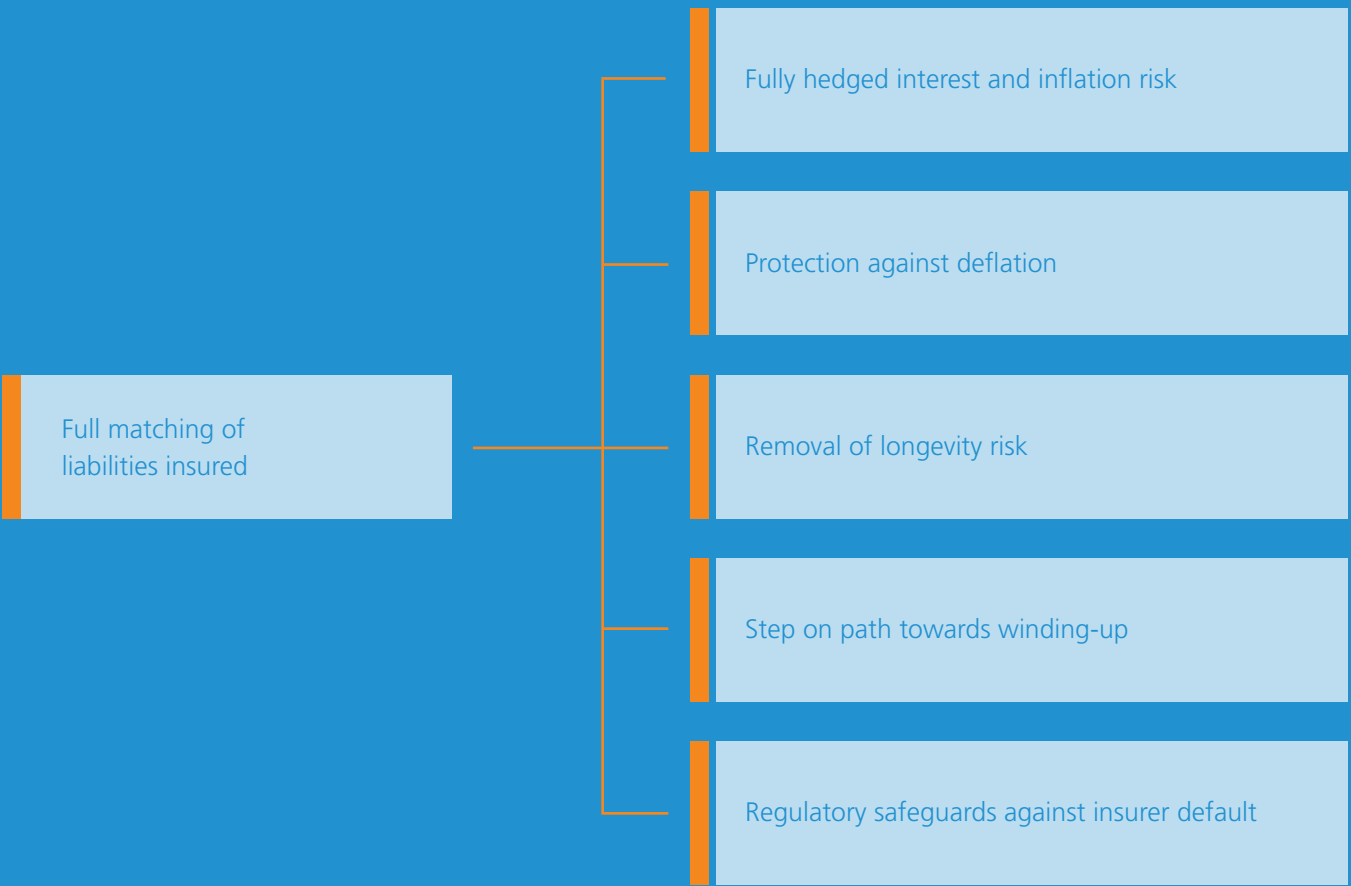
In addition to the factors included in the chart, the majority of insurers also emphasised the importance for a new provider to have a robust administration capability and a high-quality member service offering.

Transaction affordability

PENSIONER BUY-INS

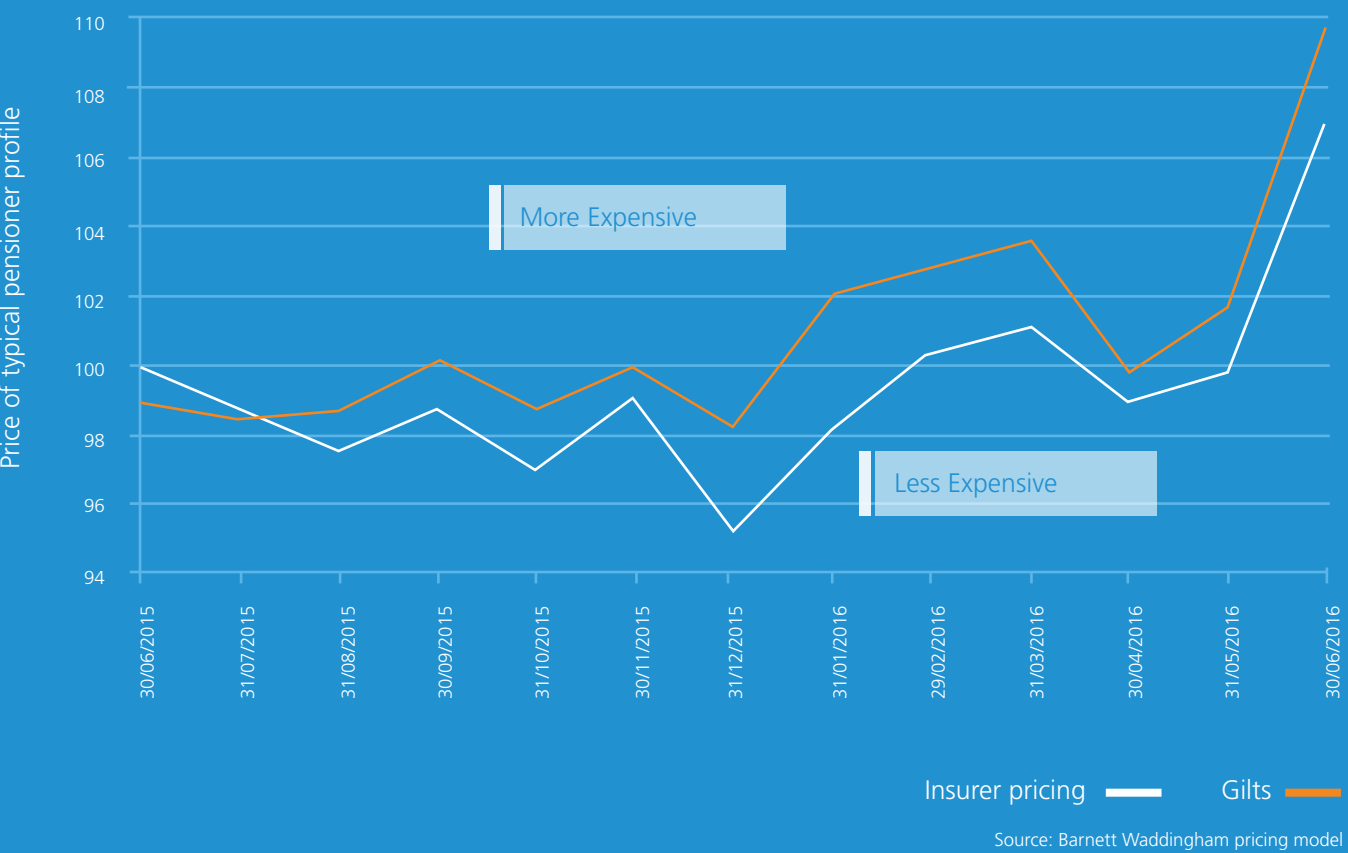
Since the introduction of Solvency II from 1 January 2016, pensioner buy-in pricing has remained attractive, particularly for those schemes looking to exchange gilts for a buy-in policy. This level of pricing has been supported by the continued strong appetite of the insurers, and also during the first part of the year by a widening of corporate bond credit spreads (the difference between the yield available on gilts and corporate bonds) which tends to improve the pricing relative to gilts.

WHAT DOES A BUY-IN PROVIDE?



The following chart shows the movement of pensioner pricing relative to a corresponding measure of the liability based on gilt yields. Over the last 12 months, insurer pricing has generally remained below the 'gilt-based' measure, highlighting the potential for schemes to exchange their gilts at no additional cost. Our pricing model (based on data from a number of the main insurers) indicates a sharp rise in rates between 1 June and 1 July of around 5%-10% following the EU Referendum. However, gilts and swaps have increased in value in a similar way (depending on duration and other asset specific factors), maintaining the relative potential affordability of a bulk annuity for schemes holding these assets.

PENSIONER PRICING



The volatility in pricing as market conditions change reinforces the importance for schemes to have carried out the necessary preparatory steps so that they are well placed to take advantage of market opportunities as they arise. Many schemes are now choosing to closely monitor the relative cost of a transaction and have a clear plan ready to move forward if a transaction appears affordable.

In practice, insurers are still adapting in response to Solvency II in order to best optimise their position within the parameters of the new solvency regime. Since the beginning of the year, we have seen wider variations in the pricing provided by the insurers, especially at the initial tender stage, with the position differing from one transaction to the next. This greater granularity in pricing from insurers is likely to reflect the

internal approaches adopted under the regime and the ability to source suitable assets at that point in time. This emphasises the benefits of seeking pricing from as wide a range of potential providers as possible.

However, the impact on the level of pensioner pricing that can ultimately be achieved appears to have been broadly neutral following the introduction of Solvency II. A brief summary of Solvency II is shown opposite.

EU REFERENDUM

The Brexit result from the EU Referendum had some immediate significant impacts on the financial markets. In particular, the yields available on long-term gilts and interest rate swaps fell by around 0.5% p.a. on the news of the outcome. In absolute terms, this fall in yields increased the cost of a typical pensioner buy-in by the order of 5%-10%.

However, a widening of the gap between gilt yields and corporate bond yields, for example as a consequence of the ongoing economic uncertainty, can actually improve the relative affordability of a transaction for schemes using their gilt holding to fund a buy-in or referencing to a 'gilt-based' funding target.

In addition, if a transaction requires some additional funding from the corporate sponsor where this is ultimately coming from an overseas parent, the weakening in sterling means that this funding may appear cheaper and so increases the viability of the transaction.

The result will generally lead to a prolonged period of uncertainty and volatility while the impact and terms of the UK's exit continue to develop – including any changes in the political landscape and interventions from the Bank of England. Therefore, schemes should monitor the position carefully to identify any buy-in or buy-out opportunities.

SOLVENCY II

Solvency II is the new EU-wide regulation governing the way in which insurers are funded. It became effective from the start of 2016 – transitional arrangements apply to bulk annuities transacted before its introduction. In practice, the main effect has been to increase the level of capital reserves required for bulk annuity business, and so influencing the insurers' pricing offered to pension schemes.

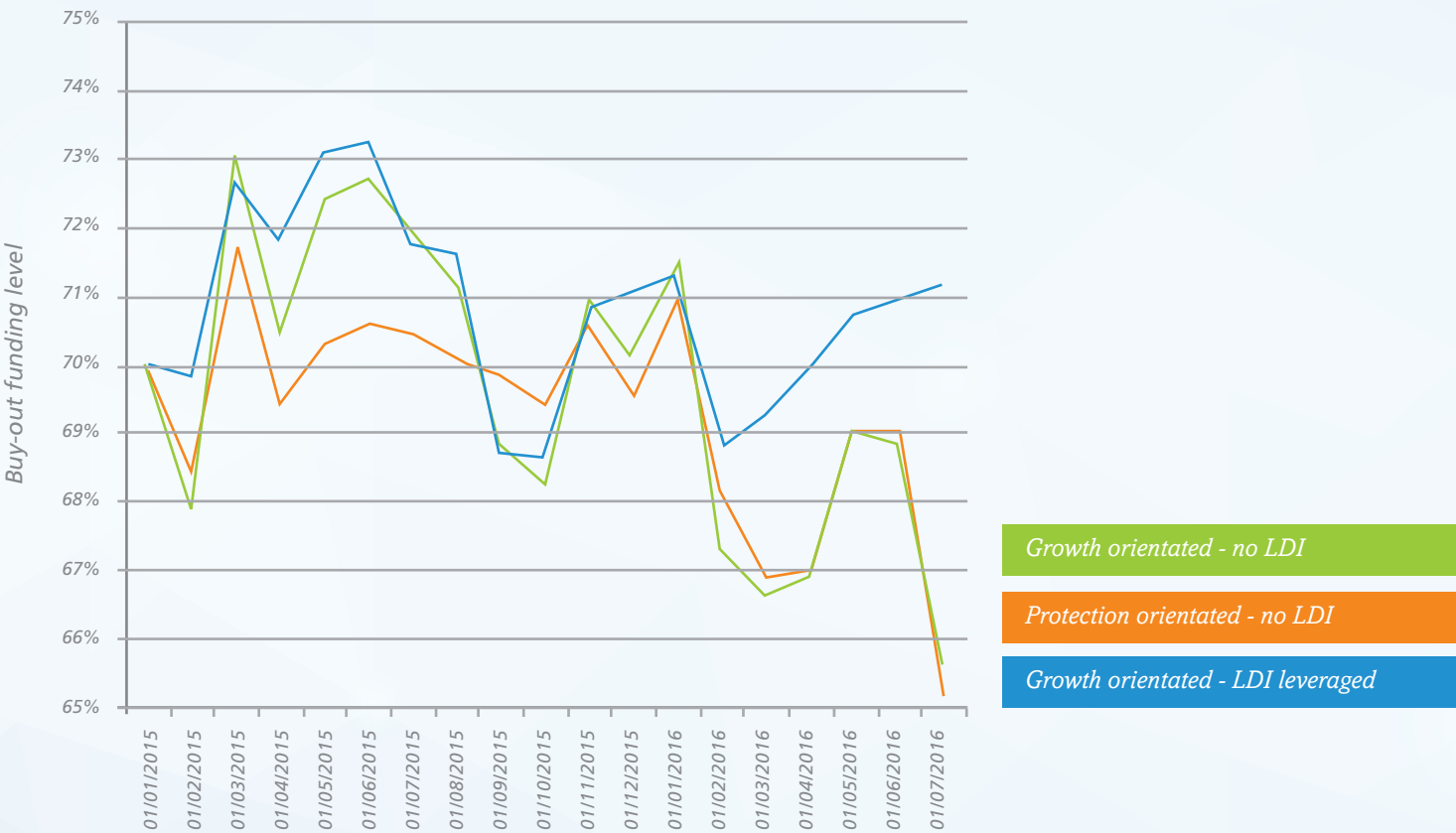
A key aspect of the regulations is Matching Adjustment, which is essentially an easement which allows insurers to take credit for an additional element of investment return in excess of the 'risk-free rate' in determining their reserving requirements. Fundamental to approval for Matching Adjustment is certainty around future asset cashflows and their matching of the liability cashflows. This has required some insurers to repackage certain assets in order for them to qualify for the easement.

Another significant area for bulk annuity insurers has been the treatment of longevity risk within the Risk Margin required under Solvency II. The inefficient capital treatment means that insurers have typically sought to reinsure longevity risk to reduce the adverse impact under the new regime.

SCHEME BUY-OUT

For the vast majority of schemes, while their anticipated time horizons may differ, there will be an underlying aim to move towards buy-out or some form of self-sufficiency target. The movement in the buy-out position for schemes over the last 12 months or so will depend on their own specific circumstances, in particular their investment strategy, initial funding level and their maturity (i.e. respective level of pensioner and non-pensioner liabilities).

For those schemes with a significant level of interest rate hedging in place, this hedging has helped to support funding levels over the last year, particularly given the initial financial impacts of the referendum result. This will especially be the case for schemes with a swaps based Liability Driven Investment (LDI) strategy, as yields on swaps have reduced relative to those on gilts. The following chart illustrates the movement in the buy-out position for a notional scheme, which on 1 January 2015 had an estimated buy-out funding level of 70% (modelled for a range of asset strategies).



*Based on Barnett Waddingham's pricing model for illustrative scheme, half deferreds and half pensioners.
Growth assumes approx. 60% in equities (split equally between UK and overseas) and remainder in gilts, bonds and LDI.
Protection assumes approx 80% in gilts and bonds (split equally) and 20% in equities (split equally between UK and overseas).*

The impact of Solvency II on pricing has been greater for non-pensioner liabilities compared to pensioners, reflecting their longer duration and increased uncertainty.

For non-pensioners, the introduction of Solvency II has also increased the need for trustees to pay careful attention to any aspects of a transaction which may affect the insurer's ability to obtain the Matching Adjustment easement – being unable to obtain this easement can dramatically increase their capital reserving requirements. For example, member option factors, such as commutation factors and early retirement terms, may need to be reviewed at the planning stage of the transaction where these are fixed under the scheme rules or set at relatively generous levels.

FEASIBILITY AND MONITORING

In assessing the feasibility of a bulk annuity, it is important to consider both the relative value and affordability of the transaction.

Firstly, does the transaction represent 'good value' compared to the risk and return characteristics of other alternative strategies - taking into account both the financial and longevity risk reduction offered by a bulk annuity transaction?

Secondly, is it affordable in terms of the funding implications (and so any additional contribution requirements) and also in the wider sense of the assets being used for the transaction? For example, the assets may be needed for some other purpose such as providing collateral under a leveraged LDI strategy or for direct hedging protection for the wider scheme liabilities. It is important to take into account these wider funding and risk considerations, as well as the

potential implications for the cashflow of the scheme. From the perspective of the sponsoring employer, the accounting implications may also be a significant issue, and can sometimes influence either the feasibility or preferred timing of a transaction.

Identifying an explicit pricing target or necessary implied return on the policy can form the benchmark for assessing insurer quotations. Our bulk annuity pricing model, reflecting current pricing information from a range of leading insurers, can be used to support the initial feasibility stage of transaction and help develop appropriate financial metrics for the deal. If a transaction is not immediately affordable, then monitoring the position against the appropriate metric (e.g. pricing target, asset valuation, funding measure etc.) will be needed.

Illuminate, Barnett Waddingham's online analytical tool, can be used to track the relative affordability of a buy-in or buy-out on a real-time basis, using the information from our bulk annuity pricing model.



Greater clarity and focus for your pension strategy



IMPROVING AFFORDABILITY

Liability management exercises can play a significant role in improving affordability, either in the general lead up to a transaction, or more directly integrated within the bulk annuity purchase process. The introduction of the pension freedoms has increased the potential attraction of transfer options for members, albeit with some risks of selection from members.

For pensioners, a pension increase exchange exercise (PIE) can be used to reshape benefits to make them more attractive for insurers and so reduce pricing. For example if increases are linked to CPI or there are certain upper or lower limits that are applied to the inflation rate, these could be exchanged for different initial pension amounts but with more suitable increase rates.

For non-pensioners, offering the deferred members a flexible retirement option (FRO) can lead to a saving relative to the buy-out cost. A FRO allows members aged 55 or over to transfer out their benefits to take advantage of the new flexibilities, securing benefits in a different form or using them for draw-down purposes. Facilitating partial transfers, while increasing the level of complexity, could also be more attractive to members and increase the level of take-up. These could be focussed on those benefit elements which may be relatively more costly to insure.

From the insurer side, there are a number of innovations which can be used to help improve the immediate affordability, rather than the absolute pricing, of a transaction. These include variations on the option of deferring some of the premium (to make them more efficient under Solvency II) as well as forward starting buy-in arrangements where the insured pension payments kick in at a future date and the scheme remains responsible for the pension payments in the shorter term.

Insurers are also looking at the option of allowing schemes to retain certain risks associated with the liabilities or supporting assets. For example, due to the insurers solvency requirements some risks may be more economically held by the scheme, helping to improve immediate affordability and potentially facilitating the coverage of the remaining risks.

Case study

De-risking journey for £300 million buy-out - TKM Group Pension Scheme

BACKGROUND

- The Trustees of the TKM Group Pension Scheme and the Company, Inchcape plc, had previously adopted a long-term de-risking plan to reduce risk and target buy-out.
- Barnett Waddingham advised on a LDI strategy to manage the key investment and inflation risks, with a pension increase exchange exercise implemented in 2012 helping improve buy-out feasibility.
- In mid-2015, it was decided to progress the buy-out with the aim of insuring benefits by the end of 2015.
- We acted as trustee adviser for the buy-out transaction.

TRANSACTION PROCESS

- We worked closely with all parties including the company advisers, scheme lawyers, administrators and insurers, liaising effectively with stakeholders in order to meet the short timescales.
- A comprehensive online data room was used to support the full market tender process:
 - the scheme having nearly 5,000 members; and
 - a relatively complex benefit structure due to previous mergers.

- Our investment specialists advised the trustees on further modifications to the asset portfolio to provide closer matching to insurer price movements during the tender process.
- Following the trustees' selection of Aviva as the preferred insurer we advised on the:
 - final asset portfolio adjustments to facilitate in-specie transfer; and
 - implementation of a tailored 'price-lock' mechanism.

BENEFITS TO THE CLIENT

- Completion of the initial buy-in transaction and going 'on-risk' with the insurer by mid-November - comfortably ahead of the challenging target.
- Successful achievement of the trustees' goal of moving towards buy-out and meeting the deal objectives of the sponsoring employer.

Medical underwriting

Medically underwritten transactions more than doubled their share of the total bulk annuity market in 2015, representing over 12% compared to around 5% in 2014. Excluding the largest transactions, this market share was even more significant (based on information from JRP Group), with over a quarter of all sub £100 million transactions including some form of medical underwriting.

The strong market growth reflects the extremely competitive pricing achieved, with schemes being able to transact at around, or potentially below, their funding reserve and achieve implied returns significantly in excess of gilts. Whilst Legal & General completed the largest underwritten transaction at the end of 2015, the vast majority of the deals to date, totalling over£2 billion, have been carried out by the medically underwritten specialists, Just Retirement and Partnership (now JRP Group following their merger in April 2016).

The underlying premise of medical underwriting is that, by obtaining existing health and lifestyle information about the specific members being covered by the transaction, the insurer is able to assess their longevity more effectively and reduce any margins for prudence in their assumption setting. For a traditional insurer, in assessing longevity, they will typically use proxy rating factors for the members such as pension amount, occupation and postcode, as well as age and gender. Therefore medical underwriting can be seen as a variation on the traditional route rather than as a new product.

Whilst medical underwriting has been an important factor in the attractive pricing which has been achieved, it is not the only one. The pricing has also been influenced by the direct competition between the specialist insurers and their strong appetite to grow the market. In addition, the specialists' underlying investment strategies involve a significant element of equity release or lifetime mortgages as part of

their backing assets. These assets can offer relatively attractive long-term yields for the insurer and so help support competitive pricing for schemes.

The impact of the merger of Just Retirement and Partnership, the leading specialists in the underwritten market, will be interesting to see. Although this removes some of the direct competition in the market, we expect medical underwriting to continue to grow and offer an attractive de-risking option for schemes.

For example, insuring the largest liability members ('top-slicing') offers an effective way for schemes to manage any concentration of longevity risk associated with these members. For some other schemes, the approach adopted by a traditional insurer in assessing longevity may simply be a poor reflection of the scheme's underlying mortality characteristics.

ENGAGING WITH MEMBERS

Health and lifestyle information is typically obtained using a combination of an initial short member questionnaire, telephone interviews and individual GP reports.

A successful exercise clearly depends on achieving a good response rate from members, and some trustees may have initial reservations about the likely participation of their members or the nature of the information gathering process.

From our experience, and supported by wider market comments, an effective communication process can result in very positive member response rates to the requests for information – of the order of 80-90% plus. In cases where the number of individuals being insured has been particularly small, we have also sought 'in-principle' feedback from the members about their participation before deciding whether to proceed.

COLLECTING THE DATA

For the data gathering process:

- a more detailed level of information will only generally be required for some of the members being insured – the focus is on those members with larger liabilities and/or where the initial questionnaire indicates an issue;
- the information is collated by specialists with established processes and experience in handling sensitive data;
- all the information is based on existing medical data - no new data is sought; and
- the trustees have the ability to review the member communication materials and process.

Very broadly the additional processes for an underwritten transaction are as follows:

MEMBER COMMUNICATION

Members introduced to process and issued medical questionnaire
Permissions sought for telephone interviews / GP reports

DATA GATHERING (HISTORIC MEDICAL CONDITIONS)

Telephone interviews / GP reports obtained
Focus on members with higher liabilities or where issues have been indicated

INFORMATION SHARING

Assuming competitive process, access to secure central data hub provided by third party
Data supplied in common format to each insurer

MEDICAL UNDERWRITING / PREMIUM ADJUSTMENT

Assessment of individual member longevity using medical information
Insurer transaction pricing reflecting specific characteristics of scheme members

SUITABLE TRANSACTION PROFILES

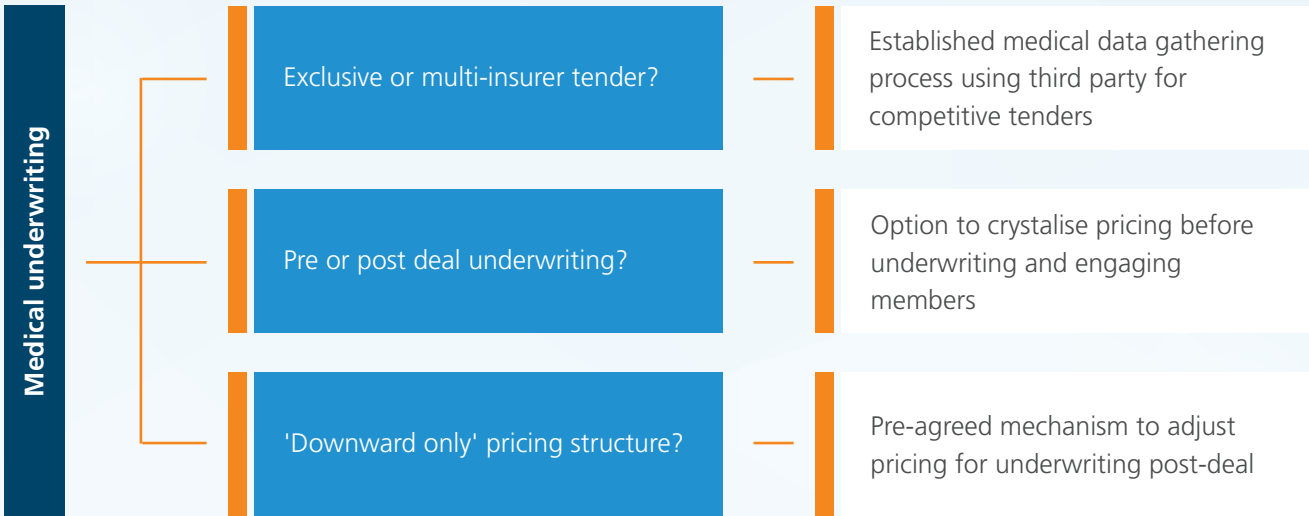
The decision whether to proceed down the medically underwritten route, rather than a traditional approach, is an important consideration for trustees. It can be problematic for schemes who obtain medical data, do not transact, and then seek a traditional quotation. In practice, each transaction needs to be assessed on its own merits. However, certain scheme characteristics or liability profiles may indicate that a medically underwritten transaction is more likely to be attractive, as illustrated by the examples below.

SMALLER SCHEMES	A lower number of members means that individual mortality characteristics are more likely to play a significant role in determining the premium – an increasing number of members means the overall mortality impact will tend to average due to the 'law of large numbers'.
TOP-SLICING'	Insuring a subset of members with the largest liabilities can be where the impact of medical underwriting is at its greatest. Traditional insurers can often take a relatively conservative approach to assessing the longevity for the largest liability members increasing the potential for savings from underwriting, with the additional information reducing the level of uncertainty.
'UNUSUAL CHARACTERISTICS'	Schemes where the traditional pricing approach based on factors such as postcode or pension amount do not accurately reflect the underlying mortality of the members e.g. industry sectors and occupations where members have been relatively well remunerated but their lifestyles may not reflect this, or their health may have been impacted as a result of their employment.

In each example, if the trustees or company are also aware that some of the members (e.g. especially the larger individual liabilities) have health or lifestyle factors which could impact their life expectancy then this can reinforce the case for underwriting.

DEAL STRUCTURING

Innovation in the way deals can be structured has also helped to support the growth in the medically underwritten market. In addition to deciding whether to adopt a multi-insurer competitive tender process, it also possible to carry out the medical underwriting before or after the transaction is completed.



While the underwriting process has been carried out pre-deal for the vast majority of cases to date, the use of post-deal underwriting may become an increasing feature – this approach is highlighted in the case study which follows.

For a post-deal approach, it is important to agree with the insurer at an early stage the mechanism to be used to allow for the results of the underwriting in the final price. For example, under a so called 'downward only' structure, the insurer will guarantee that the underwriting impact can only reduce the pricing for the scheme on the basis that any saving will be shared with the insurer in a pre-agreed manner.

A post-deal underwriting approach can provide additional pricing certainty where this is important. It can also facilitate insurer competition as traditional insurers who do not have an underwritten offering may be able to participate at the outset of the tender process on a non - underwritten basis - insurers will not participate on a traditional basis where medical information is made available at the outset.

Case study

"Completion of this second medically underwritten transaction in less than a year represents a further significant step in managing our pension obligations. Barnett Waddingham's expert support and advice through both buy-ins has enabled us to secure around half of the pensioner liabilities at extremely attractive pricing levels."

BRIAN TENNER

Finance Director - Renold plc

Medical underwriting – 'top-slicing' buy-ins

BACKGROUND

- De-risking opportunities identified for Renold Pension Scheme, the £250 million UK DB Scheme of Renold plc, an international engineering group.
- Two medically underwritten pensioner buy-in ('top-slicing') transactions completed in less than a year, totalling £50 million (in April 2015 and December 2015 respectively).
- Deals formed part of overall de-risking path actively supported by sponsoring employer and trustees.

TAILORED APPROACH

- We tailored the two deal structures, working closely with the insurers, to meet the specific objectives of the trustees and employer.
- First transaction – 'pre-deal underwriting'
 - optimised pricing achieved through competitive tender allowing for medical underwriting results
 - effective communication process including direct member engagement – over 90% member participation rate
 - full pricing movement transparency for chosen insurer linked to market indices
- Second transaction – 'post-deal writing'
 - exclusive insurer process with specified pricing target
 - post-deal underwriting process to facilitate timely transaction and capture market pricing
 - 'downward only' pricing adjustment to allow for underwriting results (guarantee pricing could only reduce with any underwriting saving shared on a 50:50 basis)

BENEFITS TO THE CLIENT

- Extremely attractive pricing – over 10% less than traditional pricing with implied returns in excess of gilts plus 0.5% p.a.
- Successfully achieved desired level of pricing transparency and certainty
- Full risk removal for highest liability pensioners including the associated concentration of longevity risk.

"Working closely with the company, as part of the overall de-risking strategy for the scheme, the trustees had clear objectives for managing the risks associated with the liabilities for this group of members. Supported effectively by Barnett Waddingham throughout the process, the buy-in represents an extremely positive result for all parties."

WARWICK JONES

Chairman of Trustees - Renold Pension Scheme

Approaching the market – be prepared

Total defined benefit pension liabilities in the UK are in excess of £2 trillion, compared to approximately £60 billion of liabilities which have been insured in the last ten years and annual transaction volumes in the last couple of years of the order of £10 billion to £15 billion. Therefore, although not all of this liability will ultimately come to market, the inherent long-term demand from pension schemes for insured transactions is extremely large.

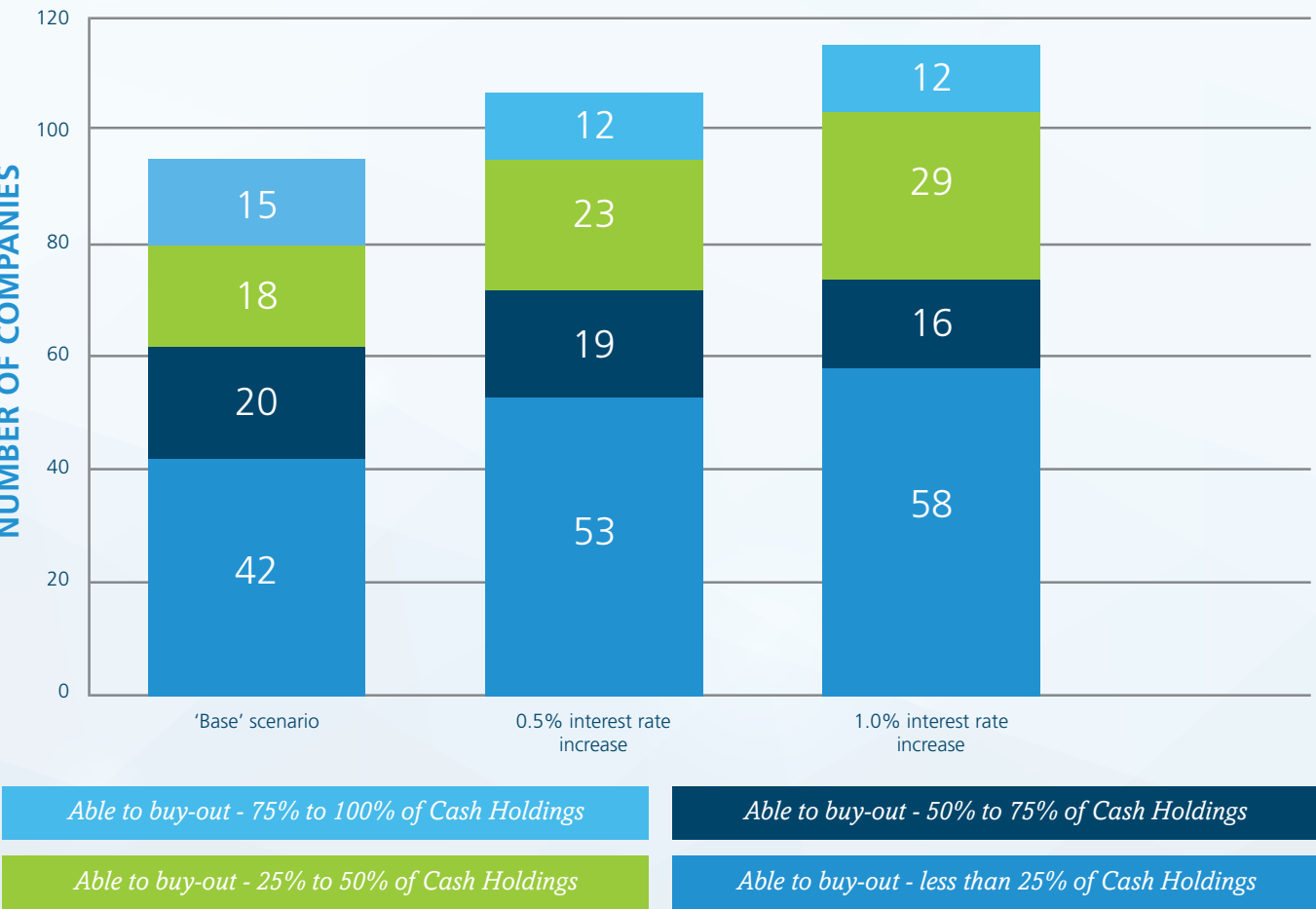
The level of demand in the shorter term could also rise dramatically over a relatively brief period if financial conditions, and in particular, long-term interest rate expectations were to materially change.

The chart below illustrates the number of employers in the FTSE350 with defined benefit schemes which would be able to afford to meet the buy-out shortfall in their defined benefit scheme using all or part of their existing cash holdings. The chart also shows the potential impact of an increase in long-term interest rates on this affordability measure (assuming increases of 0.5% pa and 1.0% pa respectively).

Clearly companies will have other uses for their cash holdings rather than necessarily de-risking their pension scheme, but it does illustrate the sensitivity of possible affordability to market conditions and the potential for increased demand.

BUY-OUT USING CASH HOLDING - FTSE350

Source: Barnett Waddingham analysis based on published financial information



INSURER VIEWPOINT

We asked the insurers to rate the relative importance of a number of key factors when making their assessment of a potential transaction coming to market. In essence, these factors represent positive indicators about the likelihood of the transaction progressing through to completion. While all of the factors may be expected to have some influence on the insurer's assessment, and be considered in the round, their relative positioning is interesting.

In addition to the factors shown, a number of insurers also noted that existing relationships with the scheme or sponsoring employer (e.g. as a result of a previous transaction), or the potential for future new business opportunities, would also play a role in their assessment.

*the relative importance of the liability profile varies significantly between insurers, in particular certain insurers are focussed on pensioner transactions only.

1. transaction affordability clearly considered
2. engagement of both trustee and employer
3. clear governance structure and decision-making process
4. liability profile* (e.g. pensioner / non-pensioner split etc.)
5. suitable preparation of member data and benefit specification
6. project plan with specified timescales
7. use of specialist advisers
8. competing concurrent cases
9. level of direct access to decision makers
10. existence of previous liability management exercises

The insurers' responses highlight that carrying out a suitable assessment of the potential affordability of the transaction has become a pre-requisite to approaching the market. As may be expected, in addition to the mutual engagement of the trustees and scheme sponsor, other key areas highlighted by their responses include the intended governance and decision-making process for the transaction, and also ensuring that the membership data is suitable for transaction purposes.

GOVERNANCE AND DECISION-MAKING

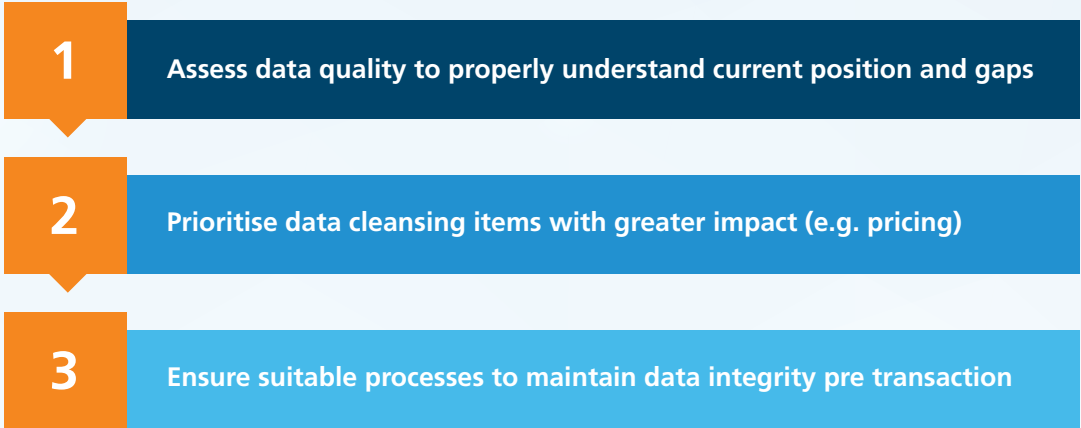
Implementing an effective governance framework can act as the underpin for an efficient and timely transaction process. Obtaining the full engagement of both the trustees and sponsoring employer from the start allows a clear understanding of their respective objectives, and means the transaction process and desired deal structure can be tailored accordingly to best achieve these.

Based on our experience, bespoke training for the relevant decision-makers can also provide an initial understanding of the transaction process and allow the main issues to be considered. Identifying any specific issues or concerns upfront can be used to help target resources and means they can be explored with the insurers early on in the process. We also find that appropriate delegation of decision-making, for example through a joint working group, can also reduce the potential for any delays.

Engagement of trustees and employer	✓
Training provided for appropriate stakeholders	✓
Clear decision-making structure with appropriate delegations	✓
Project planning – timescales, roles and responsibilities	✓
Transaction metrics and insurer selection criteria identified	✓

MEMBERSHIP DATA

Whilst membership data does not need to be perfect to approach the market, it should as at least be fit for purpose (e.g. in providing reliable quotations). In this context, this means fit, or more importantly desirable, for transaction purposes which can often differ to the data quality and completeness required for the ongoing administration of the scheme or actuarial valuations.



Ensuring a suitable level of data quality can improve insurer appetite, lead to more reliable quotation figures, help to lower pricing and also reduce the degree of data cleansing required at a later stage. Where data is absent then insurers can often take a relatively conservative approach in their assumption for the missing information leading to higher pricing – an example of this is a lack of information about members' spouses.

In addition to having full details of the members' benefits, including splits by each of the relevant benefit tranches, the following areas can often arise for consideration.

Existence/missing member checking	Need to ensure appropriate members are covered by the transaction
Mortality experience	For larger schemes, robust scheme mortality experience can be used by the insurer to help set their assumptions
Spouse details	Up to date spouse or civil partner information (e.g. marital status, spouses' dates of birth) can help reduce any prudence margins – especially for higher liability members
Contingent pensions	Current level of contingent benefit payable on the member's death can reduce uncertainty

Insurance market overview

Solvency II has presented big challenges for insurers over the past year and particularly those with annuity books. Applications to the regulator for various approvals have taken considerable time and effort. These include the Matching Adjustment, internal models and the restructuring of some assets using special purpose vehicles.

This period of significant change has led to substantial procedural differences between bulk annuity providers around how they arrange both liabilities and assets following a transaction. Whilst all firms are working to refine and improve these processes now that Solvency II is live, in the short term insurers have taken a variety of approaches and there are differentiators when assessing a provider's suitability.

The past year has (similarly to the previous 12 months) been a period of consolidation in the life insurance sector driven by the twin effects of pension freedoms and Solvency II requirements. There has been the headline grabbing merger of Just Retirement/ Partnership and Aegon selling its £9 billion annuity book to Rothesay Life and Legal & General alongside other, smaller deals. We expect such consolidation to continue in the short term as scale now brings even greater benefits, alongside the additional governance and running costs of annuity books. Smaller annuity books (sub £1-2 billion) or those not aligned with the wider business of the insurer are the most likely targets. This could have a potential knock-on effect for the appetite of some insurers for new bulk annuity deals.

We have also seen a rise in the use of reinsurance by UK insurers to ease capital pressures by passing risk on to other entities, often outside of the Solvency II regime. Longevity swaps have been the most common to date as longevity risk has become more capital

intensive. The use of reinsurance is no free lunch however as it introduces an exposure to default of the reinsurer – another risk to consider when looking at an insurer's financial strength.

April 2017 will see the introduction of the secondary annuity market, with annuity providers due to play a key role. Most (but not necessarily all) firms are expected to let policyholders sell, while some will also buy the annuities as assets. The potential size and success of the secondary annuity market is still very uncertain but we expect an initial rush with estimates varying from 100,000 to half a million current annuitants looking to sell in the first two years and numbers dropping off significantly thereafter. If the market does take off, it has the potential to improve insurer pricing and allow defined benefit pension scheme members subject to buy-outs access to the pension freedoms. However, there is significant potential for mis-selling, or at least the perception of mis-selling, and subsequent damage to brand reputations that firms will be keen to avoid.

We are yet to see the full impact of the EU referendum result on insurers, with some heralding it as a way to dilute or remove some of the more burdensome aspects of Solvency II and others concerned about the ability of UK insurers to write business on the continent. At the time of writing we have seen shares in listed UK life insurance companies fall since the vote, largely as a result of wider macroeconomic issues around the credit worthiness of corporate bonds, the prospect of a longer period of low interest rates and the impact on insurers' asset management arms. However, it is likely to be several years before we see the true effects emerge.



Longevity risk transactions

One of the defining risks of pension schemes is exposure to the longevity of scheme members – the longer a member lives, the longer a pension has to be paid out. The past decade has seen longevity expectations increase significantly. When coupled with the low interest rate environment, this has been a key factor in increasing DB obligations of sponsors.

Our research shows that between 2009 and 2015 FTSE100 companies have collectively added £8 billion to their balance sheets for the degree by which mortality improvements have exceeded their projections.

More recently, longevity trends have become the subject of debate and the most recent mortality study produced by the actuarial profession showed a significant slowing in improvement rates, although whether this will be repeated in future is far from clear.

LONGEVITY MARKET

2015 was another busy year in the longevity risk market – not just with £14 billion risk being transferred directly from pension schemes to reinsurers, but further liabilities in excess of £22 billion were passed by life insurers to the reinsurance market.

This transaction activity has been heavily spurred on by the impact of new Solvency II regulations which came into force for insurance companies on 1 January 2016 and which make it efficient for insurers to transfer longevity risk to a specialist. An understanding of longevity reinsurance will be increasingly important to ensuring best pricing terms in a buy-in or buy-out deal.

Although longevity swaps have in the past only been accessible to the largest schemes, growth in reinsurer appetite, efficiencies and innovative structures mean

that these deals will be more and more accessible to mid-sized pension schemes over the next few years – to the extent that Zurich were able to write a transaction covering just £90 million of pension liability at the end of 2015.

This is welcome news for schemes and their sponsors exposed to the risk of rising life expectancy or concentration risk, leading to higher pension contributions. And because a longevity swap leaves the scheme still in control of its assets, it can form an early step in an overall de-risking journey.

For schemes which budget for a moderate inflation risk premium for purchasing inflation-linked bonds of around 0.2% per annum then the headline cost of protecting against inflation risk and longevity risk are broadly similar.

GETTING THE RIGHT ANALYSIS

The significance of the longevity risk for a pension scheme depends on the maturity of both its members' age profile and its investment strategy.

While the risk posed by longevity is not as immediate as, say, large falls in equity values or falling interest rates, it has already proved an expensive risk to have taken over the long term. Longevity risk is largely unrewarded so the scheme is not expected to benefit from holding the risk.

Through our Illuminate system we are able to deliver detailed analysis of a scheme's exposure to longevity risk and concentration risk from high profile individuals. We can help you decide whether a particular transaction represents value for money and whether your governance budget is better focused on investment strategy or managing demographic risks.

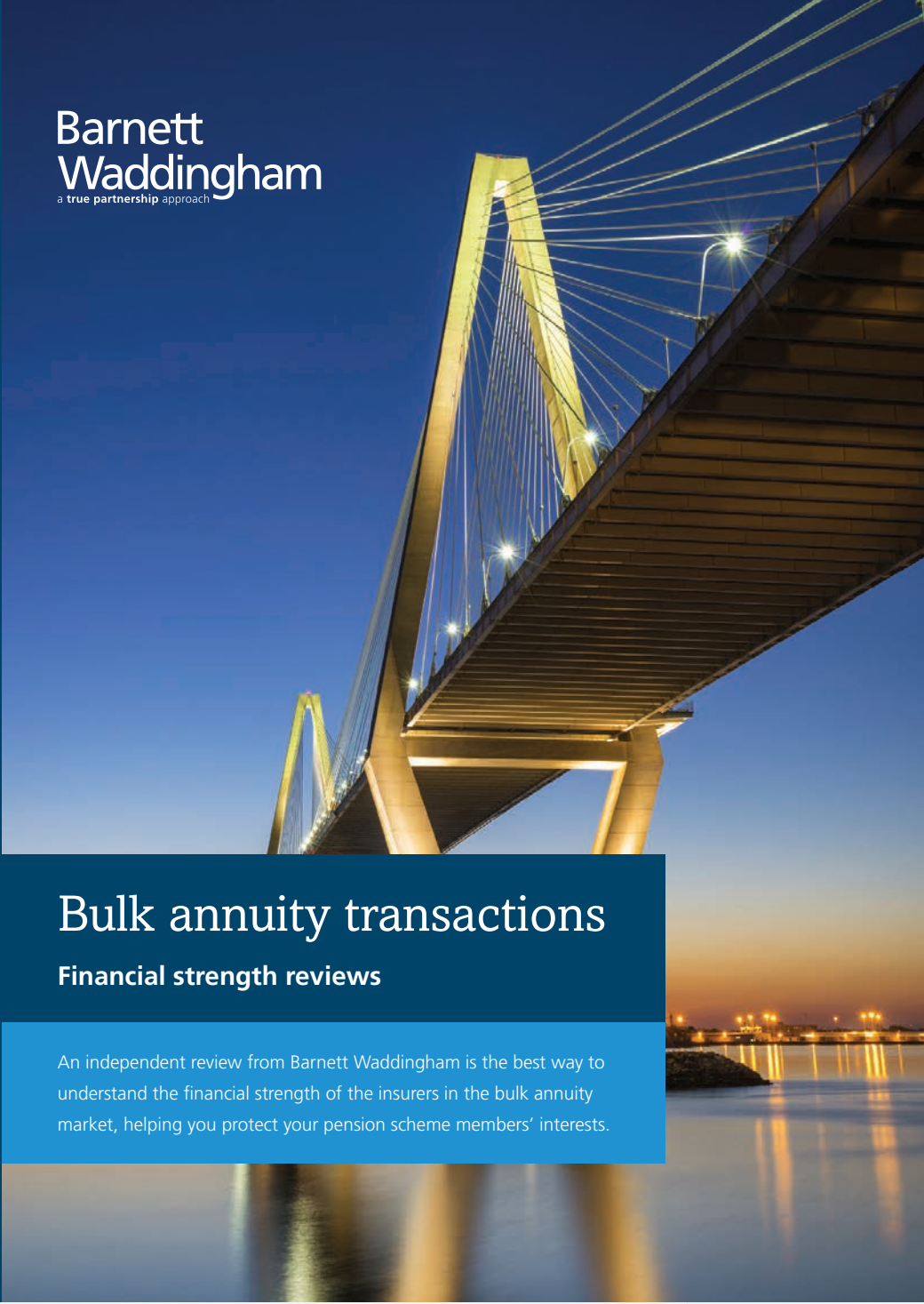


Insurer financial strength

Selecting an insurer can be an involved process, and whilst pricing is clearly fundamental in the choice of insurer it should not be the only factor considered. An important aspect where the scheme trustees and sponsoring employer need to be satisfied is the financial strength of the insurer and its ongoing ability to provide the contractual benefits.

Given the exposure to the insurer as a counterparty and the long-term nature of the commitments, in addition to understanding the regulatory regime governing insurers and the associated safeguards, it is also important to consider the insurers' underlying risks and its ability to manage these. For example, key risks for the insurer include areas such as longevity risk, credit risk on their underlying investments (including any reinsurance counterparties) and operational risk.

Barnett Waddingham's independent financial review service carried out by our specialist Insurance Consulting team offers a range of options recognising the differing needs of individual schemes. For smaller transactions this can be relatively high-level based on publicly available information. For larger deals it can be fully tailored to the requirements of the trustee and sponsoring employer and as appropriate take into account non-public information and involve specific meeting with the insurer's management. A review may be commissioned at any stage in the transaction process and can form a key part of the insurer due diligence process.



**Barnett
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a true partnership approach

Bulk annuity transactions

Financial strength reviews

An independent review from Barnett Waddingham is the best way to understand the financial strength of the insurers in the bulk annuity market, helping you protect your pension scheme members' interests.

REGULATORY SUPERVISION

Companies writing bulk annuity business in the UK are regulated by the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). The PRA is a subsidiary of the Bank of England and monitors the insurers' solvency, governance and risk management on a regular basis via a range of measures. The primary purpose of these measures is to ensure that the insurer meets its capital requirements, and if appropriate the PRA can require the insurer to take action to improve its capital position or reduce the amount of risk it has taken on.

In the unlikely event that an insurer becomes insolvent, attempts would be made initially to transfer the liabilities to another provider. If no other insurer is willing to take over the liabilities, the Financial Services Compensation Scheme (FSCS) would apply to either buy-in or buy-out policies in the event of insurer insolvency. The FSCS would pay an amount which is 100% of the benefits insured, although it should be noted that the FSCS has not been tested on a large scale. While some companies have ceased their bulk annuity operations and been sold to another provider (e.g. MetLife, Paternoster, Lucida, Synesis Life) for commercial reasons, there has not been a case to date where a bulk annuity insurer has failed.



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